38

THE JOURNAL OF ACCOUNTANCY

VOL. XXX
JULY, 1920—DECEMBER, 1920

NEW YORK
THE RONALD PRESS COMPANY
20 VESEY STREET

INDEX

The Journal of Accountancy

Official Organ of the American Institute of Accountants

Vol. 30 JULY, 1920 No. 1

Depreciation, Appreciation and Productive Capacity

By W. A. Paton

In the December, 1919, number of The Journal of Accountancy appeared an article by John Bauer, entitled *Renewal Costs and Business Profits in Relation to Rising Prices. Depreciation Reserves and Rising Prices,* an answer by E. S. Rastall, appeared in the February, 1920, issue. These articles raise some very interesting questions of accounting policy with regard to the valuation of plant and equipment assets, questions which the accountant is called upon to face squarely. Believing that the subject is still by no means exhausted the writer wishes to contribute a few comments to the discussion.

Mr. Bauer argues that the principle of accounting which should be followed in taking care of depreciation of equipment is to charge to operation the expected cost of replacement rather than the original cost less salvage. If original cost is charged to expense, he states, the investment is maintained from revenues in a formal dollars-and-cents fashion, but the physical extent and productive capacity of the plant and equipment are not so maintained in a period of rising prices. In order to maintain capacity, accordingly, a management which has adhered to the conventional depreciation policy finds itself compelled, in these days of 100 and 200 per cent price advances, to draw in new capital in making replacements. If effective replacement costs were charged to operation during the useful life of a unit, on the other hand, sufficient earnings would be reserved not merely to make good the value expiration in dollars but to provide funds to replace the property in kind.

Now the writer finds himself somewhat in sympathy with

Mr. Bauer's position. Current conditions are emphasizing sharply the need for accounts and financial statements of business enterprises which shall show as nearly as possible the actual economic situation in each case. It is coming to be more clearly recognized that both the periodic statement of financial position and the report as to interim conditions of operation should consistently reflect true pictures of current business conditions and tendencies if these statements are to form a basis for rational judgments on the part of the immediate management, the investor and other interests concerned. In other words, accounting systems must become more sensitive and accurate gauges of economic data—and certain long-standing theories and policies of accountants must accordingly undergo modification—if the purposes of the various interests in the business enterprise are to be adequately served. But while improvement along these lines is much to be desired, the inherent limitations of accounting must not be overlooked in the advocacy of fundamental changes in established accounting policies. Further, it must be recognized that new theories and plans for dealing with asset values and the expiration thereof on the books can only be adopted as technical methods are developed to express and control such schemes in a manner consistent with all the elements in the accounting structure. That is, it may be an ideal of management to maintain the productive capacity of the plant out of earnings, but we can not suffer this principle to be introduced into the accounts in such a way as to distort and misstate essential aspects of the balance-sheet. Let us briefly consider both these matters.

Ideally, perhaps, accounts should show comparative economic conditions. Comparison of the balance-sheet of December 31, 1918, with that of December 31, 1919, it might be urged, should enable one to draw a conclusion as to the relative economic positions of the enterprise at the two dates. But such conclusions, without important qualifications, can not or should not be drawn directly from the conventional accounting statements. The significance of the dollar—the accountant's yardstick—is constantly changing. We know that the 1920 dollar is a very different unit from the 1910 dollar; although it is doubtful if anyone—no matter how expert with index numbers—can tell us just what the difference is. "Dollar" is a name we attach to a varying economic

significance. One of the fundamental limitations of accounting arises here. The units of physical science are always the same; and hence direct comparisons of situations and phenomena arising at different times can be made in this field. Accountants deal with an unstable, untrustworthy index; and, accordingly, comparisons of unadjusted accounting statements prepared at different periods are always more or less unsatisfactory and are often positively misleading.

A real estate firm, for example, may have purchased a tract of land in 1910 for $100,000 and have sold the same tract in 1920 for $200,000. Ignoring interest, taxes, development costs, etc., and all other possible transactions, it now appears that the company has twice as many dollars as in 1910; which means that in terms of the conventional accounting criterion its wealth is just twice as great as in 1910. As a matter of fact the dollar may have so shrunk in significance that the concern is in no better or even in a worse economic position than formerly.

Many enterprises and many individuals have found themselves in a somewhat similar situation in the past few years. The apparent economic gain measured in dollars is often largely or entirely nominal because of the lessening value of the dollar. Many a taxpayer has felt the injustice of being obliged to pay large sums in income and profits taxes from net earnings determined by orthodox accounting methods which were fictitious as a measure of true improvement in economic condition. Here we have the fundamental case of paper profits. The profit recognized on unsold goods may measure a genuine enhancement in economic significance; the profit realized by sale of goods which does not indicate improved economic well-being is the better case of a nominal profit. No doubt certain wage-earners in recent years have found all their nominal increase in compensation more than offset by advancing prices of the things which they have been accustomed to purchase. Similarly we can conceive of a merchant (if we are not too hopelessly infected with the profiteering idea) whose buying prices have advanced so rapidly that although selling goods at a nominal advance he finds it impossible from all the funds thereby made available to replace his normal stock and is obliged, if he maintains the scope of his business, to bring in new capital. This, of course, would be an extreme case. But

the apparent improvement in the financial position of the typical enterprise in recent years is in no small degree a matter of the change in the value of money.

Accounts do not directly show true changes in economic well-being. If the value of the dollar never varied or if price changes were uniform and proportionate in all the ramifications of the economic structure, comparative economic condition would be registered in the accounts. But this is emphatically not the case. And only by taking account of the change in the purchasing power of the money unit can conclusions on this matter be drawn from comparative financial statements.

Now, while it is perhaps not unreasonable to argue that the accountant should prepare supplementary statements at the end of each period designed to show—by making proper allowances for the change in the value of money—the true comparative economic status of the enterprise,* it should be emphasized that it is above all important that the financial statements present as accurately as possible a picture of current status and current results in terms of the actual dollar of the date of the statements. And this is a matter not of general price movements—which may be said to express the fluctuations in the significance of money—but of specific price changes. The particular business enterprise does not deal with goods in general but with special classes of commodities, rights and services. Accordingly it is the function of accounting to follow the investment of the specific business, as it takes shape in various concrete economic goods, and to register the effect upon the assets and equities of the business brought about by the changing status of assets remaining in the business for considerable periods as well as of those goods and services which are highly transitory in character.

But this is not purely a matter of physical extent of plant, equipment and stocks or of productive capacity. Mr. Bauer says, "If prices were constant, both the investment in dollars and cents, as well as the physical plant, would be maintained out of earnings by including in operating account only the original cost of the property retired. But if prices have risen, then, while

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* See for a discussion of this subject, *Should Accounts Reflect the Changing Value of the Dollar?* by Livingston Middleditch, THE JOURNAL OF ACCOUNTANCY, issue of February, 1918, and *Comparative Financial Statements and the Value of the Dollar*, by H. T. Scovill, *Papers and Proceedings of the Fourth Annual Meeting, A. A. U. I. A.*, published in March, 1920.

this practice will maintain the so-called investment in terms of dollars, it will not keep up the physical condition and production of the plant. It will result in additions to capital account without enlarging the plant or increasing its productive capacity." And the evident implication of this statement is that true capital condition over a period of changing prices is properly measured only in terms of plant extent and capacity. Such a proposition could not be maintained. It would only be true if, as stated above, price movements were everywhere uniform. But this is not at all the case, as can perhaps be shown emphatically by an illustration.

Suppose the A Co. installs in 1910 an equipment of fifty units, each of which costs $500. In 1920 the company finds it necessary to replace this property; and the current cost, we will suppose, is $2,000 per unit. This sharp advance in price, it may be assumed, is not due primarily to the change in the value of money but to the peculiar conditions affecting the cost of production of these machines and to the demand for the products thereof, such as, for example, an unusual scarcity of the special manganese steel which we may assume is required in the construction of such equipment. For the same period the general price advance has been, say, 150 per cent. This may be said to measure roughly the change in the value of money. But the advance in the case of the A Co.'s equipment is 300 per cent; and the company now has a greater true capital invested whether gauged in terms of 1920 or of 1910 dollars. It takes two and one half 1920 dollars to equal one 1910 dollar, but even so the A Co.'s present capital is $40,000, measured in terms of 1910 dollars, as compared with an original investment of $25,000. It now takes more real capital (using capital, of course, in the sense of private capital) to carry on the company's operations; and if sufficient net earnings have not been retained in the business to take care of this genuine increase in capital costs it will be necessary and entirely reasonable for the management to raise additional funds by issuing new securities.

If the foregoing is sound and if it is a reasonable assumption that the accounts should show the true capital condition of the enterprise, we can conclude that depreciation charges should not be gauged by the amounts necessary to maintain the physical extent and productive capacity of the plant, unless this can be

done in such a way as to show at the same time the correct condition of proprietorship. To charge costs of replacement to revenues instead of original costs, without further adjustments, would build up depreciation reserves in excess of the book values of property retired. We would then be confronted with the unreasonable situation of having an offset or valuation credit balance on the books, although the property to which this credit was supposed to apply would have been replaced with new equipment which had suffered no depreciation. This balance in the reserve account would evidently constitute surplus; and a belated recognition of proprietary or capital increase would be forced.

In other words, an increase in capital account is inevitable when assets are replaced by more costly units. The balance-sheet consists of at least two fundamental classes of data, and a value change in one class must sooner or later be reflected in the other. The accountant can not well apply a larger or smaller yardstick to one element in the accounting structure than is applied to all other elements. Thus capital costs which have never appeared on the books as asset charges can scarcely be written off into depreciation expense. And the application of a new index to all elements should be concurrent.

In discussing this situation Mr. Rastall in his paper states that the new unit purchased at a cost of $10,000 to replace the old asset which cost $5,000 (and against which a reserve of $10,000 has been built up by charging replacement cost to revenues) would be charged to the reserve. This, he says would cancel the reserve; and the result would be the showing of an asset on the books unchanged at $5,000, although it had cost $10,000. Such procedure would not be good accounting, however. At the time the asset was abandoned the property account should be credited and the reserve charged for $5,000; and when the new equipment was purchased property should be debited and cash (or liabilities incurred) credited, $10,000. The abandonment is a distinct transaction; the replacement, another. This would leave a credit balance of $5,000 in the reserve account, which would now rate as surplus.

The solution of the matter lies in the revision of orthodox accounting policies with regard not to depreciation methods but to closing valuations. The values which the accountant uses in

closing the books and preparing statements ideally should be based upon economic conditions at the moment of closing. If plant and equipment assets were valued at the close of each period on the basis of costs of replacement—effective current costs—depreciation charges would be increased in a period of rising prices and the other concomitant effects would be registered in the accounts in a rational manner. The effect of this procedure can best be shown by an illustration.

Suppose the B. Co. buys a machine Jan. 1, 1915, for $5,000. The machine has a life of five years. From 1915 to 1920 the replacement cost of this property advances twenty per cent each year. At the end of the first year the cost of replacement would be $6,000; and to recognize this situation in the books it would be necessary to charge machine account $1,000 and credit appreciation. Depreciation on the straight line plan (and ignoring salvage) would be $1,200 for the year; and this amount would be charged to revenue and credited to reserve for accrued depreciation. At the end of 1916, there would again be a charge to property and a credit to appreciation of $1,000. Depreciation for the year would be $1,200 plus twenty-five per cent (in view of the four-year life remaining) of the new cost increment of $1,000, or a total of $1,450. At the close of each of the remaining years appreciation would be similarly recognized and depreciation charged.

It is assumed in this illustration that the advance in replacement cost has had no effect upon service life. If the price advance induced the management to make further repairs and use the property for a longer period than was originally intended the total depreciation would, of course, be apportioned over this longer life.

The depreciation charges on this plan for the years 1917-1919 would be $1,783.33, $2,283.33 and $3,283.34, respectively, the $1,000 cost increment for the last year being charged to depreciation expense for the same year in total. At the time of replacement the property account and reserve account as well would stand at $10,000. Assuming the appreciation to have been segregated (as it should be), the capital appreciation account would stand at $5,000. Somewhere among the assets, then, there would be $10,000 (in cash, merchandise, accounts receivable, etc.), retained by the depreciation charges. When the old property was

discarded there would be a charge to the reserve and a credit to property of $10,000. The purchase of a new unit would be recognized by a charge to property and a credit to liquid assets (if the assets were available in liquid form) of $10,000.

This procedure would result in the maintenance of the physical property through the recognition each year in the accounts of the effective cost of replacement, both in terms of assets and capital, and the consequent increased expense charges. The net effect is the retention of new assets to the property amount of $10,000 to replace the depreciated property and the gradual restatement of capital account to correspond.

To make this matter entirely clear it may be worth while to compare concretely, in terms of hypothetical balance-sheets, the results attained by the conventional method of valuation and depreciation with those of the heterodox plan just stated. Ignoring all other possible transactions and facts the balance-sheet of the B. Co., in above illustration would appear as follows Jan. 1, 1915:

Assets	$5,000	Capital	$5,000

Assuming that the conventional valuation plan were followed, that all net earnings were withdrawn, and again ignoring all other possible transactions, the condition of the B. Co. on December 31, 1919, just prior to the moment of replacement, could be represented as follows:

Assets (old)...............	$5,000	Capital	$5,000
Assets (new).............	5,000	Reserve for depreciation....	5,000
	$10,000		$10,000

After the abandonment of the old equipment is recognized, we would have

Assets (new).............	$5,000	Capital	$5,000

To make the replacement at the new cost of $10,000 would require a new investment of capital of $5,000; and, assuming that the additional funds were secured, that the present assets were of such a character that they could be used in the purchase of new

equipment and that the new property was acquired and installed, the balance-sheet would stand as follows:

Assets	$10,000	Capital (old)	$5,000
		Capital (new)	5,000
	$10,000		$10,000

If the cost-of-replacement plan of valuation were carried out the first balance-sheet would be as above, but the second would show:

Assets (old)	$10,000	Capital (original)	$5,000
Assets (new)	10,000	Capital (appreciation)	5,000
		Reserve for depreciation	10,000
	$20,000		$20,000

After abandonment the balance-sheet would appear as follows:

Assets (new)	$10,000	Capital (original)	$5,000
		Capital (appreciation)	5,000
	$10,000		$10,000

The company now has assets adequate to purchase the required equipment (assuming that they are in liquid form) without raising new funds; and after the replacement is made the balance-sheet will be unchanged except in regard to the identity of the assets.

Revised as has been outlined, so as to provide for concurrent adjustments of assets, expense and proprietorship, the writer believes that there is considerable merit in Mr. Bauer's contention. There is still room for argument, however, that this whole matter is one of no real consequence. The two alternatives discussed above, it may be urged, lead to the same results for the entire period involved; for, if proprietary income be conceived broadly as the net credits to proprietorship outside of investments and withdrawals, then the $5,000 credit to capital as appreciation exactly offsets the additional $5,000 charge to expense; and the effect upon the statement of net earnings throughout the five years is consequently nil. In other words, is it not folly to write assets up, crediting proprietorship for the amount of appreciation, since this will mean merely that a like increase must be charged to depreciation expense during the life of the property? If

the entire net income in this broad sense of increased proprietorship were withdrawn from the business the final status of assets and capital would be the same if cost of replacement were charged to expense as if only original cost were so charged.

This matter hinges upon the definition of income. Is the proprietary credit, which should be made when a fixed asset is charged with the increment necessary to bring the book value up to the effective current cost, in any sense an index of income? So far as its expressing improved economic condition is concerned this depends, as pointed out above, upon whether the price change in any particular instance involved is more or less acute than the general movement. In the average case it would no doubt be true that such appreciation would represent pretty largely not income but the application of the new measuring unit to the proprietary accounts. In some instances there would be an item of true economic enhancement involved; in others, a deficiency. Admitting the thesis that it is not feasible to adjust accounting figures in terms of an absolute standard of value it seems reasonable to adopt the position that the appreciation credit shown in the above case is not an item of income.

At any rate such a credit in a practical case would not measure an amount which could conveniently or safely be turned over to the stockholders. As Mr. Bauer points out, it is important from the standpoint of the management that the property be physically maintained. The increased charge to expense does retain an added amount of liquid assets provided the credit to appreciation is not included in available income. The property is maintained and capital is correctly stated—results which surely are to be desired.

It is not intended here to argue that appreciation of fixed assets should be recognized in the accounts. From the standpoint of management (which is interested in effective current costs and not in costs five years ago) and from the standpoint of the various interests which would like to see the balance-sheet really exhibit what it purports to show, viz., a correct statement of the assets, liabilities and proprietorship of a business on a given date, there is much to be said in favor of such recognition. In view, on the other hand, of the conjectural character of asset values at best and the consequent importance of conservatism, the difficulties in

the way of determining effective replacement costs in the case of complex assets, the constant fluctuation of such costs and the fact that having once made an investment the management is often thereby committed to a policy for a considerable period regardless of the movement of prices, probably most accountants would feel that original cost is the best basis upon which to value fixed assets. A management, for example, cannot scrap a $3,000,000 plant in order to take advantage of the appreciation of a $100,000 site. The site in such circumstances is virtually removed from the market for a period of several years at least.

Certainly the treasury department would not permit costs of replacement to be charged against revenues for tax purposes unless the appreciation involved were concurrently credited to revenues. An elaborate argument can be made on either side of this proposition. It has been the purpose of this paper merely to point out the limitations inherent in accounting as a means of showing comparative economic well-being; to show that cost of replacement can not be charged to expense except as the conventional method of valuation is abandoned and antecedent charges and credits are made to assets and proprietorship, respectively, so that all elements of the balance-sheet are made to reflect concurrently the changes in prices in so far as they affect the specific situation; and, finally, to indicate that such a revision of valuation policies could be adopted without the distortion of any accounting fact and, in that it would tend to maintain the physical extent of the plant in any case, would have much to commend it from the standpoint of management.

Accounting for a Magazine Publishing Business

By L. A. Buettner

The method of recording the facts of a magazine publishing business is somewhat different from the accounting of an ordinary manufacturing or trading concern. Although conducted on an instalment basis, it is nevertheless quite different from the ordinary instalment business, in that the income is not credited until each copy of the magazine is delivered. and, besides, in cancellations account must be taken of the undelivered copies as well as the cash balance on the account itself. In the explanation to follow, an effort will be made to present the required entries, in journal form, together with an elucidation of the more complicated records.

In beginning this discussion, let us assume that company X, a publishing house, publishes a magazine weekly and, besides, manufactures books that are sold with the magazine. Subscriptions are taken at a flat rate and a book is sold with the magazine at a rate slightly in excess of cost. Both are sold at one price to the subscriber. Sales are made on a commission basis only, and the first payment is collected when the books are delivered. Subsequent collections are made by collectors who are on a salary and commission basis. In addition to the subscription income, income is derived from news-stand sales, and the main source of income is advertising. The expenses usually associated with the above are subscription expenses, advertising, news-stand, manufacturing and mailing of the magazine, editorial and art costs and general expenses, comprising managerial, rent, etc., of the office. The manufacturing cost of the books is charged to finished stock, and that account is credited at cost when the books are delivered to the subscriber. The period may comprise 28 days, thus allowing four issues per period, or it can be conducted on a monthly basis. The advantages of the former method consist of (1) the fact that there are exactly four issues per period and comparisons can be made more effectively and (2) it eliminates the necessity of many accruals and adjustment entries. The 28-day period has been found easy to operate and seems preferable to the other method if the magazine

is published weekly. For a monthly magazine, the monthly period might prove more advantageous.

Advertising

The advertising income for the issues printed within the period is recorded by a charge to advertising accounts receivable for the amount billed—the full advertising rate less the agency commission—and a credit to advertising income. It then becomes advisable to set up a reserve for cash discount—allowed on payments within a given time—and a reserve for bad debts. Both these items are chargeable to advertising expenses. Beside the solicitors' salaries and expenses, rent, supplies and other advertising expenses are chargeable to advertising department expenses. At the end of each period an advertising department statement should be prepared, supporting the magazine profit and loss statement.

News-stand

The news-stand department is responsible for the shipments of copies to the news-stands and receives credit for the news-stand income. When the credit is entered for the income based upon the number of copies at the agreed rate, care must be exercised in charging to the income reserves for returns and bad debts. The reserve for returns can be well calculated upon previous experience, although it must be carefully checked against the actual returns, and the rate must be changed when necessary. It has been suggested that instead of setting up a definite percentage of deliveries as a reserve for returns, and allowing it to remain, an adjustment be made on the current reserve due to differences between a previous reserve and the actual. In other words, if a reserve was set up for 20 per cent returns on an issue and if four months later, when the issue is closed, the actual proves to be, say, 18 per cent, the current reserve should be reduced by two per cent, thus giving more income to the news-stand department for its good results. In this way, the reserve will always cover 20 per cent of the sales of the last four months. Much may be said on both sides of this question—on the one side, that the records will be more accurate, and, on the other, that the current issue receives credit for a saving that should have gone to the issue affected. It must be borne in mind that, beside past experience, another factor that will seriously affect this reserve is

the date when the issue is sent out. Late issues always bring a far larger percentage of returns than those that are sent out on time.

Manufacturing and Mailing

The actual cost of manufacturing and mailing the magazine is properly charged against each issue by the cost accounting department and the total cost per issue is charged against the magazine profit and loss each period.

Editorial and Art Costs

The editorial and art costs, comprising manuscripts, drawings and departmental salaries and expenses, are likewise charged to each issue. The actual cost of manuscripts and drawings for the issue can be easily determined by pricing each manuscript and drawing used at cost price. The articles and illustrations can be taken from a copy marked by the editorial and art department.

Administration

The administration expenses comprise, mainly, officers' salaries, rent of subscription offices, prospectuses and stretchers, repairs on damaged books and other incidental expenses connected with the securing of subscriptions and maintaining the department.

Subscription Income and Expenses

The accounting for subscription income and expenses is the most troublesome and requires careful handling and attention. The subscription is taken, the book is delivered and the first payment is collected. At the same time, the salesman is paid his commission. To record the subscription, charge magazine accounts receivable and credit a reserve—reserve for outstanding copies. For the expenses incurred, this entry is necessary:

Deferred book expense
" " delivery expense
" commissions
To stock delivered
" cash

The book expense covers the actual cost of the books delivered and the other charges cover the actual cash outlay in securing the subscription. The charges are made to deferred expense

accounts, as explained later. It then becomes advisable to set up necessary reserves, charging them to deferred expenses as:

Deferred bad debts
" anticipated cancellations
Collection expenses
To reserve for bad debts
" " cancellations
" " collection expenses

The first two reserves are set up on a percentage basis, based upon past experience. The collection expense reserve is calculated as follows:

From the total subscription deduct the amount of the first payment collected. Divide the remainder by the average amount collected per collection obtained from past experience records. The result is the estimated number of collections to be made. Multiplied by the average cost per collection, also available, this gives us the amount of the collection reserve. The charge to deferred collection expenses is written off as the copies are delivered. The actual future collection expenses incurred are charged to the reserve for collection expenses.

We have on the books at this time a deferred income in the account reserve for outstanding copies and deferred expenses, i. e. cost of books, delivery, commission, collection and bad debts. I have omitted the cancellation charge for special future discussion. We also know the number of copies to be delivered on the unexpired subscriptions. When the subscribers' copies are delivered, the income should be credited and the expenses applicable to these copies should be charged. It is readily conceivable that the total reserve for outstanding copies will be credited to income when the last copies are delivered. In the meantime, the income to be credited per copy is calculated by dividing the total deferred income—reserve for outstanding copies—by the number of copies to be delivered. This income, per copy, multiplied by the number of subscription copies delivered per issue, will represent the subscription income per issue. In like manner, the deferred expenses carried are applicable to the undelivered copies. The unit charge per copy for the definite deferred expenses can be ascertained and charged to the income credited. This method of deferring income and expenses on subscriptions and writing them off against the

copies delivered is sound in theory and is easy to apply. The entries necessary to record income and expenses on subscription copies follow:

Reserve for outstanding copies
To subscription income
To record the income on ———— subscription copies at the rate of ———— per copy.

Cost of books
" " delivery
Loss on bad debts
Commissions
Collection expenses
To deferred book expenses
" " delivery expense
" bad debts
" commissions
" collection expenses

To charge to expenses the proportionate part of the deferred expenses, based upon ———— subscription copies.

Cancellations

The manner of recording cancellations is more difficult. It is necessary to consider not only the balance on the accounts rereceivable, but also the balance in the reserve for outstanding copies and the deferred expenses applicable to that cancelled account. When the subscription is taken, an entry is made charging deferred anticipated cancellations and crediting reserve for cancellations. When the account is cancelled the balance of the account is written off by a charge to reserve for cancellations and a credit to the accounts receivable. Thus far the recording is simple. It then becomes necessary to charge reserve for outstanding copies—thus reducing the reserve by the deferred income on the cancelled copies—and to credit deferred anticipated cancellations. Then the following entry becomes necessary.

Deferred loss on cancellations
To deferred book cost
" " delivery
" commissions

To charge against deferred loss on cancellations the actual

expenses on the above cancellations which are not recoverable.

This loss is calculated on the same basis as the other charges against subscription expense. The expense on these cancelled subscriptions was originally charged to deferred expenses, and these accounts were credited with their proper amount when the copies were delivered. Consequently it is only proper to take from the deferred expenses and charge as an actual expense the unrecoverable portion of the incurred expenses applicable to these cancelled copies. Of course, all returned books are credited at cost to this deferred loss on cancelled account. This net loss on cancellations is written off on the same unit rate basis as the other expenses, as it is an actual loss. The entry necessary is

Loss on cancellations

To deferred loss on cancellations

To write off the proper proportionate part of the deferred loss on cancellations based upon ———— subscription copies at ———— per copy.

To close the matter of cancellations, another entry is necessary to record the value of the copies cancelled in excess of the amount cancelled:

Deferred anticipated cancellations

To deferred loss on cancellations

This reduces the actual loss on cancellations which must eventually be written off.

The reserves and deferred income and expenses and the number of copies to be delivered must be carefully watched and constantly checked. When necessary, rates of reserves should be increased or decreased, and the total number of copies to be delivered should be checked against the actual subscription list.

Regulation of Bond Discount

By Robert D. Armstrong

The proper treatment of discount suffered in the sale of bonds is one of the most controversial questions which public service commissions have had to face. As the result of considerable discussion and consideration, however, the fundamental principles seem to have emerged with a fair degree of clearness and, in their general outlines, are fairly well defined.

Nature of Bond Discount

In order to have a concrete example to which we can refer in this discussion, the following typical case will be found useful.

A public utility has made extensions and betterments, properly chargeable to capital account, of $100,000. Its method of financing provides for the issuance of twenty-year five per cent bonds under its mortgage to the extent of 85 per cent of the value of such extensions, viz., $85,000. It finances the remaining $15,000 either from reinvested earnings or from the sale of stock, resorting to the latter only when necessary. This is a fairly conservative plan of financing extensions and betterments. The company is able to sell these bonds at 90 per cent of par. It, therefore, realizes $76,500 on the sale of $85,000 of such bonds. This amount will be referred to as the realization, and the sum of $8,500 will be referred to as the discount.

The utility has contracted mortgage obligations to the face value of $85,000, but it has received in cash in consideration of such obligations only $76,500. The rate of interest aside from the discount, which the bondholder receives and the utility pays, viz., its annual interest charge for the face value of the bonds divided by the realization therefrom, is 5.88 per cent.

From the point of view of the utility, the essential features of the situation are that it must provide from some other source $8,500, to reimburse its treasury for that amount of the extensions and improvements, and also that at the end of twenty years it must be in position to repay or refund the full face amount of the bonds, viz., $85,000, although it has received for them in cash only $76,500. If the utility makes annual payments into a fund,

which, with compound interest at the rate of four per cent, would equal $8,500 at maturity, the annual payment will be $285.44. The annual interest charge upon the $85,000 of bonds is $4,250. The annual interest paid on the face value of the bonds, plus the annual payment into the sinking fund to amortize the bond discount, will be $4,535.44 or 5.93 per cent of the realization, $76,500.

In the example cited above the discount of $8,500 is a part of the interest which must be paid for the use of the realization, $76,500. It will be paid, not annually, but in one sum at maturity when the bonds are redeemed or refunded. This is the only difference between this form of interest and the interest which is paid to the bondholder year by year. The real rate at which the utility has borrowed its $76,500 is not the nominal rate of 5 per cent nor 5.88 per cent, but 5.93 per cent.

In the last analysis bond discount is simply a concession to the psychology of the investment market. Essentially, it represents a form of interest: the investor desires a certain interest rate on his investment and the corporation can secure money at a certain borrowing rate. The reason why bonds are sold at a discount with a low rate of interest, rather than at par with a rate of interest representing the borrowing rate, is that bonds are issued at various times under mortgages which are fixed in their terms, while the conditions of the investment market are constantly changing.

Bond Discount Not Capital Charge

Practically all commissions are agreed that no allowance for bond discount should be made in fixing the value of a utility for rate-making purposes.

In the following cases it was held that no allowance should be made for bond discount in fixing the original cost:

Lincoln v. Lincoln Water and Light Company, Illinois, P. U. R. 1917, B.

Thomas v. Jefferson City Light, Heat and Power Company, Missouri, P. U. R. 1917, B, 745.

Pine Lawn v. West St. Louis Water and Light Company, Missouri, P. U. R. 1917, B, 679.

Greensburg v. Westmoreland, Pennsylvania, Pennsylvania, P. U. R. 1917, D, 478.

In the following cases it was held that no allowances should be made for bond discount in estimating the cost of reproduction:

Re Colorado Springs Light, Heat and Power Company, Colorado, 4 Colo. P. U. C. 199.

Re Western Colorado Power Company, Colorado, 5 Colo. P. U. C.

Re Denver and Inter-Mountain Railroad Company, Colorado, P. U. R. 1918 E, 831.

Re Chicago Railways Company, Illinois, P. U. R. 1919 D, 572, 596.

Thomas v. Jefferson City Light, Heat and Power Company, Missouri, P. U. R. 1917 B, 745.

Re Kansas City Electric Light Company, Missouri, P. U. R. 1917 C, 728.

Greensburg v. Westmoreland, Pennsylvania, P. U. R. 1917 D, 478.

The interstate commerce commission refuses to allow discount on bonds as a part of the construction account.

In the following cases, it was held that no allowance should be made for bond discount in fixing the fair value for rate-making purposes:

Lamar v. I. R. L. and P. Company, Colorado, P. U. R. 1918 B, 86.

Re Colorado Springs Light, Heat and Power Company, Colorado, P. U. R. 1917 F, 385.

Re Western Colorado Power Company, Colorado, P. U. R. 1918 E. 629.

Re Chicago Railways Company, Illinois, P. U. R. 1917 B, 572, 596, P. U. R. 1919 D, 575.

Re Atchison, Topeka and Santa Fe Railroad Company, Kansas, P. U. R. 1917 F, 272.

Re Baltimore County Water and Electric Company, Maryland, P. U. R. 1918 F, 522.

Joplin v. Home Telephone Company, Missouri, 4 Mo. P. S. C. R. 64, 72.

Re City Water Company, Missouri, P. U. R. 1917 B, 624.

Louisiana v. Louisiana Water Company, Missouri, P. U. R. 1918 B, 774.

Mississippi R. and B. T. R. Company, Missouri, P. U. R. 1918 C, 221.

-Borough v. Spring Water Company, Pennsylvania, P. U. R. 1919 C, 404.

The only case that I have been able to find in which the courts have ruled upon this matter is a Pennsylvania case. The public service commission refused to make any allowance for bond discount in fixing the value for rate-making purposes, for the reason that the evidence was not sufficient that such discount had been suffered.

Ben Avon v. Ohio Valley Water Co., Pennsylvania, P. U. R. 1917 C, 391.

The superior court overruled the commission (P. U. R. 1918 A, 161, 68 Pa. Sup. Ct. 561). The court said:

> Discount on securities should be regarded as a part of the capital investment which is to be taken as the basis for fixing rates.

On appeal, however, this decision was reversed by the supreme court of Pennsylvania on February 25, 1918 (103 Atlantic, 744). The court said:

> No allowance should be made for an item of this kind in the fixed capitalization of the company as a basis for a permanent charge against the public.

However, the practice of three commissions is otherwise. In the case of the *Potomac Electric Power Company,* District of Columbia, P. U. R. 1917 D, 563, bond discount was allowed as part of the original cost, because when the expense was incurred, it was so classified by the system of accounts prescribed by the commission. The commission said, however, that bond discount should not be considered as a part of the cost of reproduction or in the fair value to be taken as the base for rates. In the case of *Paulhamus v. Puget Sound Electric Railway Company,* Washington (*Railroad Commission Report* 1910, p. 17) an allowance was made for bond discount of five per cent of estimated investment which had been funded in bonds. In his *Valuation of Public Service Corporations* (p. 278) Mr. Whitten says that this rule has been adhered to by the Washington commission in later decisions.

In a number of decisions the Wisconsin railroad commission has considered this question, the principal ones being the following:

Hill v. Antigo Water Company, 1909, 3 W. R. C. R. 623, 646.

Janesville v. Janesville Water Company, 1911, 7 W. R. C. R. 628, 659.

Marinette v. City Water Company, 1912, 8 W. R. C. R. 334, 342.

Green Bay v. Green Bay Water Company, 1913, 9 W. R. C. R. 236, 253.

In summarizing the practice of the Wisconsin commission. Mr. Whitten says:

> The rule appears to be that bond discount actually incurred will be considered in determining original cost and actual investment, but that it will not be considered in an estimate of the cost of reproduction.

Whether it should be considered in estimating original cost depends altogether upon whether the realization or the total face value of the bonds was originally charged to capital account. If the former, it is not objectionable to charge bond discount to capital account; if the latter, the item is charged twice. The real criterion is the actual physical value of the property purchased with the securities or the proportion of such value that is funded in bonds. It is immaterial whether this is charged in two entries—one the realization and the other the discount—or in one entry, viz., the full value. But in no case should both face value and discount be charged.

The Indiana commission set forth its views at some length in the case of the *Citizens Telephone Company of Columbus,* No. 4050, November 22, 1918, (P. U. R. 1919 B, 352). In this decision, the commission ruled that bond discount is essentially a form of interest which if capitalized would be a permanent charge, even though in the meantime the original bonds had been discharged with a profit; that patrons should not be obligated to bear the lack of credit of the utility; and that there should be no relation between a utility's means of securing money and the valuation on which consumers should be called to pay a reasonable rate of return. It was also said that if bond discount is to be capitalized, the public is entitled to demand that the interest rate alone shall be the rate of return and that there shall be no differential between the rate of return allowed and the interest rate.

In a recent letter H. C. Spurr, of the Lawyers' Co-Operative Publishing Company, said:

> I have always been of the opinion that bond discount should neither be capitalized nor allowed as an operating expense; that when rate-payers provide for adequate return for the full amount of the investment, they have done all they ought to be asked to do; that it is immaterial to them whether the owners of the utility put up their own money or borrow somebody else's; that bond discount is part of the interest the borrowers have to pay on borrowed money; that if the consumer is to pay interest on the borrowed money, he should, in addition to that, be required to pay a return merely on the equity of the owners of the utility in the property.

The best thought on the question whether or not bond discount should be charged to capital account in a rate-making valuation seems to be summarized in the statement of the Indiana commission in the case of the *Citizen's Telephone Company,* mentioned above:

> The proposal to capitalize discount cannot stand in the light of analysis. Large interests have abandoned such contentions. It is the policy of this commission to require the amortization of discount on securities. The purpose is to maintain a parity between the par value of the bonds sold and the value of the property added from the proceeds of the sale.

Amortization Charge Not Operating Expense

It is therefore improper to charge bond discount to capital account, for the very purpose of the amortization requirement is to put the discount on an annual basis and to pay off and retire it annually. As an annual charge there are two places to which it might conceivably be charged:

1. Operating expense.
2. Net income.

While in some cases the annual amortization charge has been allowed as an operating expense, the overwhelming weight of authority is to the contrary. In the following cases the charge was not allowed as an operating expense but required to be deducted from net income:

Re Southern Counties Gas Co., California, P. U. R. 1915 E. 197.

Re Chicago G. W. R. Illinois, P. U. R. 1915 A. 800.

Re Peoria Railroad Co., Illinois, P. U. R. 1915 A. 804.

Re Nat. Tel. and Tel. Co., Illinois, P. U. R. 1915 A. 872.

Re Tyrone Tel. Co., Illinois, P. U. R. 1916 E. 708.

Re City Water Co., Missouri, P. U. R. 1917 B. 624.

In the case of the *Hydro-Electric Light and Power Company* No. 2895, October 17, 1918 (P. U. R. 1918 A 325), the Indiana commission allowed the amortization payment as an operating charge in a rate case charge. In the modified order of June 3, 1919, this ruling was reversed and no allowance made. In the case of the *Madison Light and Fuel Company,* No. 4580, July 23, 1919, the Indiana commission allowed amortization of bond discount as an operating charge, in view of special circumstances of that case.

I have been able to find only one other case where an allowance was made for bond discount in operating expenses, and even there the ruling is not clear. (*Re Blue Hill Street Railroad Co.,* Massachusetts, P. U. R. 1915 E 370). The company was allowed to amortize the item "from earnings," but it is not clear from the decision whether the charge is to an operating account or to net income. Apparently, however, the company was allowed as an operating expense the interest on the floating debt incurred to borrow money to the amount of the discount.

If bond discount is a form of interest, as has been shown above, the charge belongs with other interest charges, viz., deductions from net operating revenue. In other words, out of the funds available for return on investment should be paid the interest for the use of money borrowed to purchase part of that investment.

Amortization Charge and Rate of Return

Bond discount, therefore, should not be regarded as a capital charge, nor should an annual payment to amortize it be regarded as an operating charge. As a form of interest, it is part of the cost of obtaining the money, and as such is an important element in fixing a reasonable rate of return. Reverting to the concrete case cited above, the rate of interest that should be considered in fixing the rate of return is not 5 per cent—the nominal rate—nor yet 5.88 per cent—the nominal interest payment divided by the realization—but 5.93 per cent—the nominal interest payment plus the annual payment to amortize discount, divided by the realization.

The following cases hold that the annual amortization payment should be considered in fixing the rate of return:

Re Southern Counties Gas Co., California. P. U. R. 1915 E 197.

Lincoln v. Lincoln Water and Light Company, Illinois, P. U. R. 1917 B 1.

C. N. S. and M. Railroad Company, Illinois,. P. U. R. 1918 A 338.

In a brief recently filed with the Indiana commission by the Laporte Gas and Electric Company in a rate case, the following statement was made:

> Nothing is included in this valuation for the cost of financing, such as discount on sale of securities, brokers' commissions and similar items, as it is thought that this should be taken care of in the rate of return allowed on the value of the property.

In its brief on questions connected with the valuation of railroads, filed with the interstate commerce commission, the presidents' conference committee said:

> The rate of return should, of course, cover the element of discount, for discount is simply a method of equalizing interest.

There has been much controversy whether bond discount should be considered in connection with the valuation or the rate of return allowed in rate-making cases. In a sense, this is purely a matter of accounting; if the practice is consistent, estimated revenue requirements of the utility will probably be about the same.

The first objection to considering it as a part of the rate base is that a temporary disparity is produced between the actual value of the property and the rate base, which, if not properly regulated by a continuing policy, will become permanent and will be charged against the public indefinitely. On the other hand, if it is not considered in determining the valuation, but instead the annual charge for amortizing it is considered in estimating reasonable rate of return, no permanent capital charge is incurred by what is essentially a result of temporary circumstances. If bond discount is charged to capital account, the rate of return should be correspondingly lower, so that the desired net income will be the same as if it were not so charged and as if the amortization requirement were considered in connection with the rate of return.

The second objection is that there is a real distinction between the two elements which must be considered in estimating the revenue to which a utility is entitled above its operating expenses. The valuation should be determined by the cost of the property

used and useful in the public service. The main consideration in fixing the rate of return is the annual interest charge which must be incurred, including the amortization of the discount, in order to secure the money to fund that cost. After rates are fixed upon a reasonable value and a reasonable rate of return, the purpose of the amortization requirement is to see that the revenue derived from such rates is devoted to the purposes for which it was allowed, and that the deferred interest is paid year by year.

In the case of the *Southern Illinois Gas Company,* Illinois, P. U. R. 1916 C, 704, the commission said:

> Bond discounts are but another way of expressing rate of interest. Should a study be made of the findings of the various state commissions in rate-making proceedings, it will be discovered that the commissions, in determining a reasonable rate of return, have taken into consideration the interest rate which should be allowed in order that bonds may be sold to net par to the company and have considered bond discounts as an interest rate in another form.

Amortization of Discount

Bond discount amortization requirements have one of two ends in view:

(1) The paying off and retirement of the sum of the discount, or

(2) The annual reinvestment of earnings in the property to the total amount of the discount.

The first is based on the theory that only the realization, viz., $76,500, has been borrowed, and that the discount, viz., $8,500, is interest, to be paid in one sum at maturity. The second is based on the theory that the entire sum, viz., $85,000, has been borrowed, but property only to the amount of the realization has been secured therefor, property to the amount of the discount to be added year by year by the amortization payment. In the former case, the proceeds of the amortization payments are held in cash against the maturity of the bonds; in the latter case they are invested in property which is not charged to capital account, since it was capitalized in advance when the bonds were issued and the money borrowed. The Indiana and Illinois commissions, among others, hold to the former theory, and the New Hampshire commission holds to the latter theory. (*Re Hampton Water Works Company,* New Hampshire, P. U. R. 1918 C 171.)

A variation from the first form of amortization is permitted by the Illinois commission. (*Re Tyrone Electric Company,* Illi-

nois, P. U. R. 1916 E 708.) Instead of making equal annual payments into the bond discount amortization fund, the utility is permitted, if the commission finds it proper, to make only one payment, which is equal to the total discount. This is done by charging the discount to profit and loss when the bonds are issued, and thus withholding it from net income applicable to dividends.

This is not objectionable, for it secures the same result. Either method forces the utility to pay the total cost of the money it borrows and prevents it from paying out in the form of dividends the part of such cost that is deferred.

Bond Discount at Maturity

In the case cited above the utility realizes from the sale of bonds \$76,500 and from the sale of stock \$15,000, a total of \$91,500, as compared with a total capital liability and property added to its plant of \$100,000. If not permitted to issue further securities to the amount of the discount, it must provide \$8,500 from reinvested earnings or temporary loans to pay for the property it has purchased. This reinvestment of earnings must not be confused with the amortization payments, which properly are not deductions from earnings at all, but merely a form of annual interest payment during the life of the bonds. Its purpose is to solve the problem created by the difference between the face value of the bonds assumed and the money that was received from their sale. This money must be provided in some way, and to provide it is an immediate problem.

Whether by reinvestment of earnings or by temporary loans, it will be provided, and property thereby will be purchased whose value is equal to the stocks and bonds issued on account of such purchase, although in addition there will be a temporary debt to the amount of the discount or a deduction from earnings that otherwise would be applicable to dividends. Since the capitalization and property value will be equal, it will be entirely proper at maturity to refund the entire bond issue on which the discount was incurred, if so desired, and with the amortization fund pay the floating debt assumed on account of the discount. If such floating debt has been repaid from reinvested earnings, it will be proper to transfer the amortization fund to surplus or distribute it in the form of dividends. The alternative would be to use the amortization fund to retire bonds to the amount of the discount, leaving outstanding

the floating debt or forcing the stockholders to leave their earnings permanently in the property.

In other words, the utility has paid for the property, including property to the amount of the discount, and has also accumulated an amortization fund equal to the discount. To pay for such property it has incurred floating debt. This debt either is still outstanding or has been retired by the stockholders; foregoing dividends which they have earned and to which they are entitled.

It goes without saying that if the utility retired bonds to the amount of the discount, it would be entitled to fund in bonds capital expenditures to the amount of the discount, which on account of the discount it has been forced to carry by temporary loans or temporarily reinvested earnings. It was not entitled to do so while the other bonds were outstanding, but the moment they are retired no reason longer exists for refusal to grant such authority.

From the point of view of the public interest, it is immaterial whether

(1) Bonds to the amount of the discount are retired, and
(2) New bonds are issued to the same amount to reimburse the treasury for property paid for by floating debt or foregone dividends, or
(1) The par value of the old issue is refunded, the value of the property purchased therewith originally being equal thereto, and
(2) The amortization fund is used to reimburse the treasury for the property paid for by floating debt or foregone dividends.

Either course would produce exactly the same result, the same amount of outstanding securities, the same value of property and the same floating debt. Whichever course is followed, at the maturity of the bonds, after all adjustments have been made, the problem of bond discount has disappeared. The utility is in exactly the same position, except for temporary inconvenience, as if it had issued bonds at an interest rate of 5.93 per cent and sold them at par.

Issuance of Securities to Cover Discount

We now pass to a consideration of whether utilities should be permitted to issue additional securities to the amount of the dis-

count suffered in the sale of bonds. The cases on this question are about equally divided. In the case of the *Chicago Great Western Railroad Company,* Illinois, P. U. R. 1915 A, 800, a railroad company was authorized to issue bonds to provide for discount on an issue of bonds for refunding capital expenditures. In the case of the *St. Louis and Santa Fe Railroad Company,* Missouri, P. U. R. 1916 F, 49, the Missouri commission made allowance for discount of bonds in authorizing securities in a railroad re-organization. In the case of the *Bronx Gas and Electric Company,* New York 1st District, 2 P. S. C. R. (1st district N. Y.) 178, decided in 1910, the New York commission authorized bonds to cover premiums and commissions on bonds previously authorized, but required the expense to be amortized.

On the other hand, in the case of the *San Diego Consolidated Gas and Electric Company,* California, 2 Cal. R. C. R. 264, cited in P. U. R. 1917 D, 853, decided in 1913, the California commission makes a very convincing argument to the effect that debenture bonds cannot be authorized to cover discount on bonds. In the case of the *Westbrook Gas Company,* Maine, P. U. R. 1915, B, 358, the Maine commission refused to consider discounts and commissions on previous capital issued in authorizing issues under a mortgage providing for an issue of bonds to the extent of 90 per cent of the cost of extensions. In the case of the *Joplin and Pittsburg Railway Company,* Missouri, P. U. R. 1919 B, 388, the Missouri commission said:

> This item has been excluded by this commission in all cases, and has practically ceased to be considered a proper item for capitalization, even by companies seeking a valuation of property.

In the case of the *Indiana General Service Company,* Indiana No. 3351, decided January 12, 1918, the Indiana commission refused authority to fund bond discount in bonds, upon the theory that this indebtedness should not be capitalized but should be extinguished by an amortization account provided for that purpose.

In the case of the *Muncie Electric Light Company,* Indiana No. 1556, decided May 26, 1916, the Indiana commission denied this company, which was the predecessor of the Indiana General Service Company, authority to fund bond discount in preferred stock, even though the discount was being amortized from earn-

ings and the proceeds were being invested in additions and betterments to the plant. The commission said:

> The commission is of the opinion that said company should not be given authority to sell its preferred stock to cover said bond discount. The proceeds arising from said amortization account should be applied in extinguishing the remainder of said loan, to wit, \$106,351.25, and not in making additions and betterments. The proper application of an amortization account is to the extinguishment of a debt and not to the creation of betterments and additions.

In the case of the *Merchants Heat and Light Company,* No. 4732, September 23, 1919, the Indiana commission refused the company authority to fund bond discount in common stock. The commission said:

> The commission has refused to authorize securities to cover bond discount, or to allow for bond discount in valuing utility property (citing cases), and has taken the position that bond discount is a form of interest, and is not properly chargeable to capital account or operating expenses (citing cases). Instead it requires that bond discount be amortized during the life of the bonds, and that the annual amortization charges be deducted from income.

In its last case involving this question, No. 4938, March 31, 1920, the Indiana commission reiterated its position, and denied the United Public Service Company of Rochester authority to issue \$62,500 of bonds to refund \$50,000 of bonds maturing. The commission said:

> The commission cannot approve the issuance of \$62,500 of bonds to refund \$50,000 of bonds now maturing. In similar cases it has consistently held that refunding issues should be of the same total par value as the bonds refunded. To adopt the position which petitioner asks the commission to assume would result in increasing the mortgage indebtedness of utilities each time a refunding is negotiated. Where the total outstanding bonds approach or equal the value of the property, such a course would be doubly unwise. It would soon make the total of the mortgage indebtedness greater than the value of the property mortgaged. Bonds issued under such circumstances would be of questionable value.
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> In the last analysis this is a petition to issue bonds to cover bond discount. It proposes permanently to capitalize petitioner's lack of credit and the high interest rate it is forced to pay. The commission has consistently refused to authorize the issuance of any kind of securities to cover bond discount (citing cases). Bond discount is a form of interest and should not appear in the capitalization of a utility. The purpose of amortizing the discount is to put it on an annual basis like other forms of interest.

One more class of cases remains to be considered: where issuance of securities to cover bond discount, while regarded as undesirable as a general practice, was permitted in case of financial emergency. In the case of the *New York and Richmond Gas*

Company, New York 1st District, P. U. R. 1918 F, 449, the commission said:

> Upon the facts of the present case, I have no doubt that the provisions of the public service commission law permit the commission in its sound discretion to authorize an issue of bonds for purposes ordinarily chargeable to operating expenses or to income. The appellate division in the *Dry Dock* case (135 N. Y. S. 344) has so indicated. The commission has itself done this a number of times, as, for instance, where, owing to a sale of, say, four per cent bonds at eighty instead of six per cent bonds at par, the issue of a greater amount of bonds is necessary in order to finance the desired amount of proceeds. In such a case the additional amount of bonds issued to make up discount is charged to income, and is properly regarded to be amortized out of future income during the term of the bonds.
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> Generally, under normal conditions, it is, of course, preferable that no bonds be sanctioned for purposes chargeable to operating expense or to income, even with a provision for amortization during the period the bonds will be outstanding. War-time conditions may call for a relaxing of that rule and an earnest effort to find a way of meeting the company's situation.

In the case of the *Central Maine Power Company,* Maine, P. U. R. 1918 C, 792, securities were authorized to cover the discount on previous issues of securities, as a special provision where the abnormal condition of business justified the funding of temporary obligations. However, part of these obligations had been amortized, and the amortization requirement was continued, so that at the maturity of the bonds the utility would have funds to the amount of the securities issued to cover the discount.

In the case of the *Tyrone Electric Company,* Illinois P. U. R. 1916 E 700, the utility was allowed to issue bonds, for the purchase of property, to a par value greater than the value of the property purchased. The utility was ordered not to charge the amount of the discount to operating expense or capital account, but to profit and loss or net income. This case is at variance with the general policy of the Illinois commission, and the issue of the bonds was permitted in this case only in order to insure better service.

Turning to the merits of the question, I do not believe that any sound method of financing would permit the issue of bonds to fund discount, except in the most unusual circumstances. The fundamental objection to such an issuance is that a mortgage obligation would thereby be assumed in excess of the value of the property mortgaged. If the existing bonded indebtedness of the utility were already in excess of the value of its property, the issuance of bonds in excess of the property added would bring still nearer the in-

evitable collapse of the utility's credit and foreclosure of the mortgage, with loss to the bond-holders. If the value of the property bonded were substantially equal to or larger than the existing bonded indebtedness, the issuance of such bonds would reduce the margin of safety and finally imperil solvency.

A possible objection to this position is that only the realization has been borrowed and not the face value—in other words, that the face value of the bonds is not the true debt of the utility, for the sum representing discount represents only deferred interest payments on the realization.

If this is true, it may be asked what objection can be raised to the issuance of additional bonds to the amount of the discount. The answer is that the face value of the bonds indicates not only the amount of the debt but the amount to which the property is mortgaged. The amount of the mortgage should not exceed at the outside 85 per cent of the value of the property securing it. This means that the face value of the bonds issued on account of extensions and improvements should not exceed 85 per cent of their value, irrespective of our theory as to how much debt is assumed when bonds are issued at a discount.

The same reasoning applies with equal directness, although not with equal force, to the issue of stock for such purpose. It is true that by such issue no additional mortgage obligations are assumed and the solvency of the company is not endangered. But it is no less true, on the other hand, that securities are issued to a higher face value than the value of the property, and this is bound to result in over-capitalization and its attendant evils.

If securities of any sort to cover bond discount are sold upon the market, they pass into the hands of innocent third parties. If securities of any kind are issued in excess of the value of the property acquired with the proceeds, the result is to make the securities of the company of doubtful value. The fundamental object of security regulation, it seems to me, should be to prevent any further issuance of securities in excess of the value of the property purchased with the proceeds, and to reduce such disparity if possible where it is already in existence. If public utility securities are to be safe investments, and capital is thus to be attracted to the public utility field, there can be no compromise on this principle.

It is true that stocks or bonds could be temporarily issued to

cover the item of bond discount and be retired at the maturity of the bonds. But unless there are adequate safeguards, the proceeds of such sale might be dissipated, and the objects of security regulation thus be defeated. If such stocks or bonds were authorized temporarily, sound financing would require the raising of a sinking fund to retire at maturity the securities issued to cover discount. If this were required, the issuance of securities to cover bond discount would be of no advantage to the utility, except that it would have the use for a time of money representing the discount, which it would immediately have to begin to pay back serially. It is perfectly clear that the permanent funding of an expense which is not properly a capital charge can not be permitted, and that, though temporary funding might be permitted, it would be of very small advantage, if any, to the utility. Moreover it is much easier to get securities issued than it is to get them retired. Any issue of securities whatever to cover this item is a rather desperate expedient to secure money and displays a dangerous disregard of the future day of reckoning.

The net result of refusing to authorize securities for bond discount is to force the utility either temporarily to reinvest earnings applicable to dividends to such amount or to borrow money to anticipate such reinvestment for a short term. In the case above cited where the utility has sold $15,000 of stock at par and $85,000 of bonds at 90 per cent of par, it has realized from the sale of securities only $91,500 with which to pay for $100,000 of property. To reinvest immediately earnings of $8,500 would not be a hardship, for any utility which makes extensions of $100,000 in one year would have an amount of capital stock in comparison with which $8,500 would be quite negligible. If, however, the utility desires to postpone part of the reinvestment to another year, it can do so by incurring temporary debt which it can retire from future net income, and the burden of reinvestment will be still easier. To require the re-investment of earnings to the amount of the discount deprives the stockholder of nothing to which he is entitled, for it increases his equity in the property proportionately; moreover at maturity there will be provisions for repaying the amount reinvested, either in the form of surplus or in the form of dividends.

If earnings are too low to permit reinvestment to the amount

of the discount, the condition of the utility is very precarious indeed. Any securities it might issue would be of very doubtful value, and to authorize such securities might reflect seriously upon the commission.

After all, no securities, either stock or bonds, should be issued except to fund capital charges—and bond discount is not a capital charge. Floating debt, however, can properly be increased to reimburse the treasury for operating expenses, operating deficit, discounts, capital charges or any expenses whatever. A temporary matter, such as bond discount, should be financed only by temporary means, not by the issuance of securities which will be a permanent part of the utility's capitalization.

There is a serious question whether under the Indiana law the issuance of securities for bond discount is permissible. Section 90 of the public service commission act, which states the purposes for which securities may be issued, does not include bond discount among them. Section 89 provides that securities may be issued only to an amount "reasonably necessary" for the purposes recognized in section 90. The issuance of securities to fund bond discount is not reasonably necessary for "the acquisition of the property," "the construction completion, extension or improvement of its facilities," or any of the other purposes for which bonds may properly be issued, because there is another easier, safer and more conservative method of securing the funds, viz., reinvestment of earnings or temporary loans not secured by mortgage, to be retired from future reinvested earnings.

From the point of view of the commission, there is an additional advantage in refusing to authorize the issuance of securities to cover bond discount. The commission has had occasion in many cases to question whether the discount at which bonds were being sold was not excessive. There has been tremendous pressure on the commission from time to time to permit an excessive discount. If the commission adopts the policy of requiring the reinvestment of earnings to the amount of the discount, utilities will tend to issue their securities under terms which will make it possible to sell them at or above par, thus removing the question of the treatment of bond discount altogether.

In conclusion, any practice that results in disparity or increases any existing disparity between capitalization and value is incorrect

and is based upon wrong theories. To issue stock or bonds to fund bond discount would have this result. It is clear that bond discount is a form of interest rather than a capital charge, and differs from other interest only in that it is paid in one sum at maturity instead of annually. The practice of requiring its amortization causes this interest charge to be met annually and prevents the dispersion in dividends of the funds necessary to meet it at maturity. To require temporary reinvestment of earnings or the incurring of temporary floating debt to the amount of the discount is far better both from the standpoint of the utility and of the public than the issuance of securities in any circumstances or with any provisions for retirement.

A sound policy in regard to bond discount therefore contains four elements:

(1) The issuance of bonds to a par value not greater than 85 per cent of the value of extensions and improvements.

(2) The issuance of no securities, either stocks or bonds, to pay for such part of the cost of extensions and improvements as cannot be realized by the sale of stock and bonds to the par value of the cost of the property added.

(3) The building up during the life of the bonds of an amortization fund which will equal the discount at maturity, the annual payments to be deducted from income.

(4) The use of the amortization fund at maturity for the following purposes:

- (a) To retire bonds to the amount of the discount, if earnings have not been reinvested in the property to such amount during the life of the bonds, bonds of the original issue only to the amount of the realization being refunded, or
- (b) To repay to the stockholders either in the form of undistributed surplus or dividends the amount of reinvested earnings, if earnings have been reinvested to the amount of the discount during the life of the bonds, the full par value of the original issue being refunded.

Accounting for Proprietary Preparations

By John H. Devlin

In order properly to consider the salient features of accounting for proprietary preparations it will first be necessary to outline the commercial economics of the industry. While the following observations might apply in general to all trade-marked preparations including foodstuffs, paints, etc. (except as to the percentage of gross profit), they have special reference to patent medicines, toilet preparations and the like.

It is seldom that a highly capitalized corporation is launched for the initial manufacture and sale of proprietary medicines and toilet preparations on an extensive scale, as the sales for the first few years are usually of such slow growth that heavy fixed charges would prove disastrous financially. The accountant, therefore, will generally find that a corporation of substantial size in this industry is the successor to a much smaller business entity and that on the books the asset "formulas, trade-marks and goodwill" obtrudes itself very conspicuously, as in most instances it properly should. However, in this trinity just why goodwill is customarily stated last is not evident, as it nearly always in such cases has a preponderating value. It is only in exceptional cases that the formulas, apart from the goodwill, have a high market value, as it is not difficult to imitate or substitute the average formula; but, conversely, the goodwill of popular proprietary preparations frequently will command an exceedingly high price though divorced from the formulas.

This leads to the suggestion that whenever the respective cost values can be obtained it is advisable to set up goodwill, trade-marks and formulas in separate accounts. Accepted accounting doctrine does not approve of fluctuations in the goodwill account, but trade-marks account may be increased by the cost of securing registration of additional trade-marks and in some cases also by the cost of successful litigation in protecting trade-mark rights, while formulas account may be increased by the cost of acquiring new formulas or improving old ones even though this cost may be in the form of salary paid to a staff chemist, and the account

may be decreased by the cost of discarded formulas. When the three factors are combined in one account and a comparison of periodic balance-sheets discloses changes in the account the question arises as to which factor has been changed.

In enterprises of the type under consideration the gap between production cost and selling price is usually wide, the gross profits generally averaging from 60 to 65 per cent. This margin is made necessary by the heavy cost of advertising and other selling expenses. Therefore in the profit and loss statement interest centers on the selling rather than on the manufacturing costs, reversing the general rule, and it is incumbent on the accountant appropriately to analyze selling expenditures so that intelligent periodic comparisons may be made of the various factors comprising the cost of the selling effort and the exhibit of increases or decreases and percentages to sales.

The advertising account should be sub-classified into appropriate divisions, as for instance, publication advertising, poster advertising, window display material, demonstration expense, circularizing, free samples, etc.

Usually a sample or booklet is offered free in the advertisements, the latter being keyed so that statistical records may be kept of the number of replies from each advertisement for the guidance of the advertising manager.

If sample size packages are sold the revenue from this source should be carried in a separate sales account as the percentage of gross profit is likely to be considerably smaller than on the regular sales. The profits from the sale of samples might consistently be considered a reduction of advertising expense rather than a trading income.

Toward the close of the fiscal year, should extraordinary advertising expense have been incurred, the returns from which may not be expected until the following year, it will be appropriate to withhold such expenditure from the current profit and loss account, and to defer the amount under the caption "prepaid advertising expense."

Cuts, electros and drawings for advertisements may also be temporarily capitalized as deferred charges, but proper periodic reductions of the account should be instituted to cover the value of obsolete cuts and drawings and worn-out electros.

In other balance-sheet and administrative accounts the classification and procedure would be much the same as for any other manufacturing and trading partnership or corporation.

Manufacturing Costs

The management not infrequently will be found apathetic toward the proposition of installing a complete cost system on the theory that the selling price is standard and cannot be made to reflect the fluctuations in cost and also because there is a wide margin of safety between cost and selling price.

If the only function of a cost system were determination of exact cost there would be some logic in this argument, but it happens that a true cost system has another attribute—it is a potential agency for the reduction or stabilization of costs.

In considering the best cost system for proprietary preparations it should be borne in mind that in many cases the cost of the preparation itself is equalled or exceeded by the labor and material and overhead cost of packing, and it will be necessary to ascertain the cost of each of these two elements of the completed marketable product separately and then combine them, especially as the method of cost finding is likely to be different for the two elements.

Finished Bulk Product Cost

Finished bulk product cost comprises the liquids, pastes, powders, pills and tablets (compressed powders) in bulk before being enclosed in standard unit packages.

If the laboratory is a large one and its output consists of products of distinctive classes it would be advisable to departmentalize it for cost accounting purposes; but if methods of manufacture and character of products permit, it may be treated as one department, particularly if the products are exclusively liquid.

The manufacturing process as applied to liquids is almost entirely a chemical one and there is practically no direct labor in the cost accounting sense. The manual work consists mainly of moving material for the purpose of filling or emptying vats, etc. Labor is, therefore, a secondary rather than a primary cost element. The process hour basis for determining the cost of liquids will generally prove the most satisfactory. The process hour rate,

to be applied to all productions utilizing the process facilities during the cost period, is determined as follows:

$$\frac{\text{Total operating costs of process for period}}{\text{Total process time of all production process for period}} = \text{process hour rate for period}$$

If there are several processes or departments in the laboratory a separate hour rate should be determined for each process or department. The operating costs of a process will include not only such items as superintendence, repairs and depreciation on equipment, floor space charges, power, heat and light, insurance, etc., but also laboratory labor.

Through the medium of process time cards the periods of time each production order for a specific product has been in process is reported to the cost department. The total hours on these cards for the cost period divided into the process costs for the period will give the process hour rate in accordance with the foregoing formula.

To the process cost of each production order will be added the material cost, ascertained from material requisitions on the stockkeeper or from material-used reports, to find the complete cost, at which cost entry will be made on the finished bulk product stock records according to product.

The process hour basis may also be employed satisfactorily in finding the cost of mixing pastes, powders, etc., but the conversion of powders into pills and tablets is frequently a machine operation and it will be necessary, to find the cost thereof, to utilize the machine hour, direct labor or kindred basis.

Part Finished Bulk Product Cost

In some laboratories several materials are combined to form a part finished bulk product which is a common constituent of two or more finished bulk products. In such cases a production order should be issued for a specific quantity of the part finished product and the cost should be determined by the same method as for finished bulk products. When completed the part finished product will be recorded as such on the stock records at the ascertained cost and charged out of stock at this cost when it goes back into process to become part of a finished bulk product.

Material Cost of Bulk Products

If conditions will permit, it is, of course, preferable to deliver to the laboratory out of the store-room (on a material requisition) the exact quantities of materials required for a given production order. Such requisitioned quantities will be credited on the stock records and charged to production at the stock record costs. As care must be observed, however, to avoid too much red tape this method is not always feasible, especially when it is desired to maintain secrecy as to formulas or when there are numerous ingredients to a formula, some of them in minute quantities.

In such cases the accountant will have to be content with a static material cost based on the chemist's estimate, but it may be approximately verified, and adjusted if necessary, from time to time through the medium of material-control accounts properly classified.

Finished Packed Product Cost

As previously suggested the cost of packing material, labor and overhead is often even greater than the cost of the product itself, so that accurate and illuminating analysis of the packing cost is of paramount importance.

Material

The items entering into the cost under the heading of material will usually be found to embrace a part or all of the following:

Finished bulk products (to be packed);

Bottles, jars, collapsible tubes, tin, wooden or pasteboard boxes;

Corks, rubber stoppers, screw caps, patent box covers;

Labels, paper seals, etc.;

Folding paste-board cartons, corrugated wrapper cartons;

Containers to hold standard quantity of unit packages, as for example ½ dozen, 1 dozen, etc.

With the exception of the first mentioned item, there is no reason why the cost of any of these materials used on a given production order cannot be found accurately through the agency of material requisitions and proper stock records, particularly if production orders are issued for standard quantities, as for example 100 gross, 500 gross, etc., at a time. The employment of counting machines will simplify the counting of small items such as corks, labels and the like.

In some cases the exact quantity of the finished bulk product

required on a given production order may be conveniently requisitioned and delivered to the packing department, but there are other instances wherein this is impracticable, as for instance where the product is delivered to the packing department through a piping system. When this condition exists the quantity packed may be closely estimated by multiplying the number of packages completed by the average quantity per package plus a proper percentage for spillage. The production order will be charged and the stock records credited accordingly.

Labor and Overhead

The basis for ascertaining the labor and overhead cost will be governed largely by the character of the operations in vogue.

The operations will usually be found as follows:

Filling (enclosing product in bottles, jars, collapsible tubes, etc.);

Closing or sealing (affixing cork, screw cap, cover, etc.);

Labelling (attaching one or several labels to a single package);

"Cartoning" (inserting bottle, jar, tube, etc., in individual folding carton or corrugated paper carton). This operation frequently includes insertion of printed matter and samples in the carton.

"Containering" (packing a standard quantity of unit packages in container).

The direct labor basis of cost accounting for these packing operations will usually prove both simple and reasonably accurate, especially if piece-work prevails, as it often does. In some plants all these operations are entirely manual, while in others filling, corking and labelling are done by special machines either individually operated or more or less automatic. In such cases the machine-hour basis may be adopted, which will provide for the inclusion of the packing department overhead in the machine-hour rate.

With the direct-labor basis, the percentage that the entire overhead cost of the packing department bears to the entire packing direct-labor cost should be computed for the cost period and this percentage applied to the direct-labor cost on all production orders for the cost period.

GENERAL LEDGER CONTROL OF COST SYSTEM

The cost system may be controlled by the following general ledger accounts:

Laboratory raw materials.
Packing raw materials.
Laboratory work in process.
Packing work in process.
Part finished bulk product.
Finished bulk product.
Finished packed product.
Cost of goods sold.

Materials requisitioned will be credited to the appropriate material accounts and charged to the proper work in process accounts.

Finished production orders will be credited to the indicated work in process account and charged to the proper part finished or finished product account. The cost figures entered on sales tickets will be credited to finished (packed) product account and charged to cost of goods sold account.

The foregoing is merely a bare outline for a cost system. Further details would be largely influenced by the conditions current in any given plant. What might be cost medicine for one plant not improbably would prove to be cost poison for another.

Some Difficulties in Percentages

By Leroy L. Perrine

To an accountant percentages are familiar friends. It is safe to say that few reports are submitted to clients, particularly those reports relating to audits, which are not plentifully sprinkled with percentage signs. The increases or decreases in the current year's business, as compared with the business of the preceding year; the ratio of items of expenses such as advertising, wages, rent and the like to the total of sales or to the total of all expenses—these and various other statistics are frequently expressed in terms of percentages, thus facilitating a more thorough understanding of the various phases of the business. So frequently are percentages used and so simple is it to compute the vast majority of them on tabulating machines or by pencil or "in our heads," that some accountants, more particularly those in the junior grades, are apt to treat them too lightly. In this brief article, an attempt will be made to describe a few of the more difficult percentage computations—probably, however, to most accountants, not particularly difficult, but merely unusual.

Probably one of the most frequent errors in the use of percentages is in their addition or subtraction. Relative to this it is well to remember that percentages can be added or subtracted only when they result from dividing by the same base or divisor. A simple illustration of this principle is shown in the case of determining percentages of the total expenses for various individual expenses. For example:

Expense	Amount	Percentage of total
A	$ 80,000	32%
B	70,000	28%
C	40,000	16%
D	60,000	24%
Total	$250,000	100%

The accuracy of the above percentage computations is obvious. The base, or divisor, for computing all five percentages is the

same, namely, $250,000; and it is correct to add the percentages so derived. The fact that the sum of the first four percentages is 100 per cent is a partial check on the correctness of the work, although such an addition would not disclose any "switches" which might have been made.

A different situation is shown in the following table, and illustrates the fallacy of what accountants sometimes call "getting the average of an average." This situation is frequently confusing. How it works out is set forth below:

Branch	Sales	Cost of sales	Ratio of cost of sales to sales
Store A.........	$100,000	$ 70,000	70.00%
Store B.........	200,000	150,000	75.00%
Store C.........	75,000	60,000	80.00%
Store D.........	25,000	21,000	84.00%
Total	$400,000	$301,000	75.25%

The above is the correct computation of percentages. But instances have been known where the percentage of the total of the four branches has been computed by adding together the first four percentages, and then dividing this result by four; in other words, dividing 309 per cent by 4, giving 77.25 per cent as the incorrect result. Such a method attaches as much weight to the relatively large percentages of the two small stores as to the relatively small percentages of the two large stores and is manifestly erroneous. It is never correct to use this "average of an average" method. To find the final percentage, the right method is to divide the total cost of sales by the total sales. Occasionally the result obtained by the "average of an average" method will coincide with the result obtained by the first method, but this will not be a proof that the latter result is correct. It will be merely a coincidence and not a habit.

The preceding table shows how percentages are sometimes incorrectly added. The following table shows how they may be occasionally incorrectly subtracted:

	Year ended Dec. 31, 1919	Year ended Dec. 31, 1918	Increase	Percentage of inc. or decrease
Gross earnings......	$90,000	$80,000	$10,000	12.50%
Operating expenses..	60,000	55,000	5,000	9.09%
Net earnings....	$30,000	$25,000	$5,000	20.00%

The only difficulty whcih sometimes arises from tables like the above is in working out the last percentage. It is practically the universal custom to consider the figures of the preceding year as the base (or divisor) figures, and not those of the later year. The different figures in the third column are the dividends, and the percentages in the last column are the quotients. The first three amounts on the net earnings line are, of course, merely the differences between gross earning and operating expenses, and sometimes young accountants make the mistake of assuming that the percentage on this line may also be obtained by differencing. This method will seldom work out the correct result; and if it does, it will, as stated above, be only a coincidence and prove nothing.

The above tables have involved only what are sometimes called "black figures." The most confusing problems in percentage computations, in the opinion of the writer, are those which deal with "red figures," or, more accurately, those which involve both black and red figures. A simple case illustrating this difficulty is shown in the case of a man who lost $500 during his first year in business and gained $1,000 during his second year. What is the percentage of increase? Some accountants give the answer as 300 per cent, meaning 300 per cent black, obtaining this answer by dividing $1,500 by $500. But they would obtain this same result by assuming that this man gained $250 during his first year (instead of losing $500), gaining $750 on $250, which works out to 300 per cent. If two men make the same amount in their second year of business ($1,000), while in their first year one man lost $500 and the other gained $250, it is clear that the percentages of increase must be different. Both answers can not be the same. The explanation is that the first man gained 300 per cent red and that the second man gained 300 per cent black. The answer of 300 per cent red is obtained by dividing a black dividend ($1,500) by a red base ($500). The answer of 300 per cent black is obtained by dividing a black dividend ($750) by a black base or divisor ($250). Numerous errors will creep into percentage computations such as the one illustrated above, unless the distinction between red and black figures is kept clearly in mind.

The following table illustrates some computations in red figures.*

	Year ended Dec. 31, 1919	Year ended Dec. 31, 1918	Inc.—black Dec.—red	Percentage of inc. or decr'se
Gross earnings.....	$80,000	$ 90,000	*$10,000*	*11.11%*
Operating expenses.	85,000	100,000	*15,000*	*15.00%*
Net earnings...	*$ 5,000*	*$ 10,000*	$ 5,000	*50.00%*

Results such as the above are of infrequent occurrence in actual business, but occasionally something along this line develops and causes some study and possible confusion merely because of its unusual features. The first percentage results from dividing the red decrease of $10,000 by the black divisor figure of $90,000, giving a red percentage of 11.11 per cent. A similar explanation applies to the red figure of 15.00 per cent. But the red percentage of 50.00 per cent is hard to explain. Most accountants naturally consider that a red figure indicates a loss, a decrease, a going backward. Occasionally, however, this is not true. It is practically universal in accounting and statistical statements that black figures are in harmony with the caption at the head of a column, while red figures indicate the reverse. For example, in a column headed "Increase," black figures would indicate increases, and red figures would indicate decreases. But in a column headed "Decrease," black figures would indicate decreases, while red figures would have a significance exactly the reverse of their ordinary meaning and would indicate increases. In the case under consideration, therefore, the red percentage of 50.00 per cent would ordinarily convey the meaning that the 1919 net earnings were less than the 1918 net earnings. This is not the case, however, for here is a company whose net earnings actually improved in 1919 over 1918, and yet the percentage of improvement is shown in red. To be sure, the company lost money during both years, but it lost less in 1919 than in 1918 by $5,000. It made a gain in net earnings, and such a gain, it would naturally seem, should be expressed in black and not in red. Nevertheless, the red figure of 50.00 per cent is absolutely correct, and is accounted for by the fact that we are dividing a black $5,000 by a red $10,000, and the result must inevitably be a red 50 per cent.

* The author's so-called "red" figures are printed in italic; the "black" in roman.—EDITOR.

This conclusion will be clear to those familiar with algebra, where the plus sign corresponds with the black figures and the minus sign with the red figures.

In addition to cases involving red or black figures, there are other cases which might result when the figures (or some of them) are neither red nor black, but zero. In fact, by ringing the changes, there are nine possible calculations, based upon nine combinations of black figures, red figures and zeros. These will be illustrated numerically in a subsequent paragraph. Expressed in formulas, they may be stated as follows:

(1) Black (or plus) divided by black (or plus) equals black (or plus).

(2) Red (or minus) divided by black (or plus) equals red (or minus).

(3) Zero divided by black (or plus) equals zero.

(4) Black (or plus) divided by red (or minus) equals red (or minus).

(5) Red (or minus) divided by red (or minus) equals black (or plus).

(6) Zero divided by red (or minus) equals zero.

(7) Black (or plus) divided by zero equals plus infinity.

(8) Red (or minus) divided by zero equals minus infinity.

(9) Zero divided by zero equals—not computable.

The above nine formulas doubtless appear, at first sight, rather theoretical, and to most readers of this article practical illustrations will be more to the point. Following are examples of each of the above nine formulas:

	Net earnings in 1919	Net earnings in 1918	Inc.—black Dec.—red	Percentage of inc. or decrease
(1)..........	$7,000	$5,000	$2,000	40%
(2)..........	3,000	5,000	*2,000*	*40%*
(3)..........	5,000	5,000	Zero	Zero %
(4)..........	*3,000*	*5,000*	2,000	*40%*
(5)..........	*7,000*	*5,000*	*2,000*	40%
(6)..........	*5,000*	*5,000*	Zero	Zero %
(7)..........	2,000	Zero	2,000	Plus infinity %
(8)..........	*2,000*	Zero	*2,000*	*Minus infinity %*
(9)..........	Zero	Zero	Zero	Not computable

In actual practice, case (1) covers the vast majority of computations, with case (2) next in number. Cases (4) and (5) will

occur in companies where the business of the year preceding the current year has resulted in net losses. Cases (3) and (6), where the figures in the first two columns are identical, will occasionally be met. Cases (7), (8) and (9) are of rare occurrence.

From the preceding paragraph, it is clear that some percentages, even when correctly computed, may be difficult to explain. One of the most important requirements of any report, accounting or otherwise, is that it shall be fairly easy to understand. In line with this idea, the purpose in using percentages in a report should be to clarify and illumine it and to render more comprehensible the various figures contained in it. If there is any percentage computation, or group of such computations, which fails to accomplish this purpose, it would be better to eliminate it altogether. The writer has seen some accounting exhibits which were a puzzle in this respect. It is to be hoped that the clients understood them, for most accountants would not. Such intricate and involved computations remind one of the saying of Talleyrand, the great French diplomat, that speech was invented, not for the purpose of disclosing one's thoughts, but to conceal them.

It is the hope of the writer that this brief article may help to prevent some errors in the computations of percentages, or help to eliminate from reports percentages which are difficult to explain, which might otherwise creep into some of our accounting statistics.

Treasury Stock

BY RAY H. WHITEHEAD

Most of our accepted authorities on accounting terminology and procedure have correctly defined treasury stock in terms somewhat as follows: "Capital stock that has once been issued and is subsequently acquired by the issuing concern either by gift, donation or purchase and placed in the treasury. Treasury stock must not be confused with unissued stock."

With few exceptions, most of our authorities seem to have considered further discussion unnecessary. The few exceptions, however, have gone a little farther and state that treasury stock is an asset and must not be shown on the balance-sheet as a deduction from capital stock as the net worth will be thereby understated. This discussion is an attempt at answering two very important questions which our authorities have not elaborated.

What kind of an asset is treasury stock?

How is the net worth understated on the balance-sheet when treasury stock is shown as a deduction from capital stock?

When treasury stock is acquired by gift or donation there is much less to discuss, as there must be an offsetting credit to either an asset or an account called donated surplus, and it is evident that the gift or donation has been made on account of an over-valuation of assets. It is unlikely that the asset given in payment therefor is of equal value, unless the donation be considered a loan which is to be later repaid.

Treasury stock acquired by purchase is the subject of this discussion.

The assets received in exchange for shares of capital stock are construed as a "trust fund to secure creditors." To reacquire shares of capital stock by purchase, assets must be given in exchange, and when this is done the original amount representing the trust fund has been reduced.

It is a common fallacy of a great many accountants that a concern purchasing its own shares of capital stock is investing its funds in its own stock. Why is it not as reasonable to say that a concern, in liquidating its accounts payable, is investing

its funds in accounts payable? This, of course, is reductio ad absurdum. In all probability, the reasoning thus advanced arises through the legal qualification of treasury stock as a form of collateral which may be hypothecated or pledged as such to secure loans; but the discerning banker or other pledgee has certainly not considered the value of such collateral the chief factor in granting the loan.

While the lender probably does not condescend to take so critical a view of the real worth of treasury stock, it is obvious that the funds lent on this class of collateral are in the same category as the original assets given in exchange for shares of stock.

If the purchase of its own shares of capital stock by a concern reduces the amount of the original trust fund, then the assets acquired from the re-sale of these shares out of the treasury is, in effect, only replenishing the trust fund.

We often hear it argued that an investment of the funds of a concern in its own shares of stock is as much an investment as if the funds had been invested in shares of another concern. An investment in shares of stock of another concern acquires an equity in the assets of the issuing concern, plus a right to share in the earnings. An investment in shares of a concern's own stock carries neither an equity in assets nor a right to share in earnings. Treasury stock does not draw dividends nor share in the distribution of assets.

Theoretically, if it be assumed that treasury stock is an investment, an investment in shares of another concern constitutes a real investment, while an investment in shares of a concern's own stock constitutes a nominal investment.

The nominal investment, therefore, is simply an investment in a right to re-sell a certain number of shares which have been placed in the treasury, and the cost of this investment can not be said to be the price paid for the shares, because the payment for the shares was only an exchange of assets for a capital liability. The right was gratis, and the value of this right is only determined by the value received when the shares are re-sold.

A definition of treasury stock, after giving effect to the foregoing, would be as follows:

Treasury stock: a term used to denote a reduction of assets originally placed with a concern as a trust fund to secure credi-

tors. Its retention on the books may be only temporary; and its appearance on the books is indicative of a right to restore the trust fund in part or in whole.

It may be argued that the original assets received in exchange for shares of capital stock have been overlooked through merger with other assets acquired out of profits from operations. This is true; but the fact remains that, so long as the original shares are outstanding and owned by others than the concern itself, the trust fund remains intact. Although a concern may accumulate its earnings until they reach an amount far in excess of the amount represented by capital stock, the trust fund, as represented by capital stock, should, metaphorically, appear in alto-rilievo from the heterogeneous mass of assets composing the trust fund and accumulated earnings.

The net worth of a concern is the excess of assets over liabilities. If treasury stock is included among the assets of a concern the net worth will be thereby overstated. As an example, we shall assume the balance-sheet of the "A" company to appear as follows:

The "A" Company

Assets		*Liabilities and capital*	
Cash	$105,000.00	Accounts payable	$300,000.00
Inventory	200,000.00	Capital stock	250,000.00
Plant	455,000.00	Surplus	210,000.00
	$760,000.00		$760,000.00

The "A" company purchases from M, a stockholder, 50 shares at book value, viz: $184 a share, giving M a cheque for $9,200. The balance-sheet should then appear as follows:

The "A" Company

Assets		*Liabilities and capital*		
Cash	$ 95,800.00	Accounts payable		$300,000.00
Inventory	200,000.00	Capital stock	$250,000.00	
Plant	455,000.00	Less:		
		Treas. stock,	5,000.00	245,000.00
		Surplus		205,800.00
	$750,800.00			$750,800.00

The net worth, as shown by the first balance-sheet, is	$460,000.00
and as shown by the second balance-sheet	450,800.00
resulting in a net decrease in net worth of	$ 9,200.00

This is accounted for as follows:

Reduction of the original trust fund by giving back assets valued at	$ 5,000.00
and the distribution of accumulated earnings on 50 shares of capital stock amounting to	4,200.00
	$ 9,200.00

Going on the theory that the "A" company has invested $9,200 in its own capital stock, the balance-sheet would then appear:

THE "A" COMPANY

Assets		*Liabilities and capital*	
Cash	$ 95,000.00	Accounts payable	$300,000.00
Inventory	200,000.00	Capital stock	250,000.00
Plant	455,000.00	Surplus	210,000.00
Treasury stock	9,200.00		
	$760,000.00		$760,000.00

The face value of the net worth as shown on this balance-sheet is the same as the net worth shown on the first balance-sheet, although a change in assets is apparent.

This last balance-sheet is deceiving. A number of reasons may be advanced as to why a deceitful condition prevails; but the important reasons may be stated:

The total assets are inflated by the amount of treasury stock.

The net worth is overstated, because $9,200 thereof does not exist as an asset of the "A" company.

The item, treasury stock, may represent 92 shares at par value; 50 shares at book value or 100 shares purchased at $92.

When showing, on the balance-sheet, ownership of a concern's own shares, to avoid deceiving unwary creditors it is quite necessary to follow the plan of the second balance-sheet shown herewith. It should be understood that it is not necessary to cancel stock when placed in the treasury, nor is it necessary to deduct the amount from the capital stock account on the books, unless the stock has been duly retired as provided by the statutes.

There are many other points which may arise in an argument

for or against the method of showing treasury stock as a deduction from capital stock, and it may be presumed that there are those who will consider the stress put upon the trust fund a somewhat copious display of sophistry. Nevertheless the facts are before us.

The Journal of Accountancy

Published monthly for the American Institute of Accountants by
The Ronald Press Company, 20 Vesey Street, New York, N. Y.
Thomas Conyngton, president; L. G. Henderson, secretary;
Hugh R. Conyngton, treasurer

A. P. RICHARDSON Editor

EDITORIAL

What is a Certified Public Accountant?

One of the most recently enacted state laws providing for the certification of public accountants contains a clause to the effect that anyone who has had ten years' bookkeeping experience may be eligible to receive a certificate as a certified public accountant.

Such a provision is no novelty. Many state laws have similar provisions and in other cases the question of who shall be considered to have accounting experience is often left to the board of examiners or other authority, which may, if it so desires, construe bookkeeping as being accounting in the sense intended in the statute.

When the earlier C. P. A. laws were under discussion there was, we believe, a suggestion that the word *public* should be omitted, and that the recipient of a certificate should be described as a certified accountant. In opposition to this proposal it was pointed out that if the word public were omitted the significance of the degree or title would be lost, as any person skilled in accounting might then be certified as proficient in that portion of accounting which has to do with bookkeeping. It was felt that any designation which was not clearly indicative would be useless, and as a consequence the word *public* was retained, and has always been retained, in the title granted under the laws providing for the certification of accountants.

It has been estimated that there are as many so-called certified public accountants in the United States who have never practised publicly as there are who are really professional practitioners. In other words, 50 per cent of the certified public accountants of

the country under this estimate hold titles concerning which there is grave question as to their justification.

This fact has been brought quite strikingly under notice by the number of men who apply to state boards of accountancy for examination and present no evidence whatever of having been public accountants at any time, or even of any attention to become public accountants. The question then naturally arises: What is a certified public accountant? If the title means simply an accountant who understands theory of accounting and has passed a technical examination, it seems that there should be a change in the designation and the word *public* should be omitted. It is a strange anomaly if a man who has never been and never intends to be engaged in public practice can be granted under state authority the right to describe himself as something which he is not and will not be.

It has been asked why persons not actually public accountants should desire the C. P. A. title. To this the answer is obvious. It may assist the possessor in his private work and probably lends a kind of halo of expertness to his reputation with his employer.

In many states where C. P. A. laws have been enacted the persons responsible for the enactment have been men not engaged in accounting, who thought that the opportunity had arrived to acquire an official designation without any great trouble beyond the payment of a fee and the application for certification under a waiver clause of varying amplitude. In some states there have been large numbers of waiver certificates issued to bookkeepers and others who seized the right to append initials to their names.

Many of these original waiver certificates have passed out of existence by death or other change and quite a number of the recipients of certificates have voluntarily relinquished them or have allowed the fact that they are certified public accountants to be forgotten.

Possibly it was inevitable, and even desirable, that in the beginning of the movement for official recognition of accountants the lines should not be too strictly drawn. Many men engaged in corporation work and other private employment were of great assistance in bringing about recognition of accountancy as a pro-

fession, but it seems to us that the time has passed when there can be any further purpose in permitting anyone to describe himself as a public accountant who is not one.

There is only one C. P. A. law in the land which prohibits the practice of accountancy unless the practitioner be certified. Many laws specifically state that nothing contained therein shall be construed as an inhibition against the practice of accountancy. There is nothing to prevent anyone skilled or unskilled from holding himself out to the public as a professional accountant, and, of course, there is nothing to compel an accountant employed by a corporation, partnership or individual to be registered as an accountant. The whole matter is entirely optional. In other words, the C. P. A. certificate is supposed to be a kind of imprimatur to which a man or woman who is really engaged in public work is permitted to aspire.

Some states have recognized the folly of permitting every one who so desires to take an examination, and, if successful, to describe himself as a certified public accountant. Such states have set up a so-called practice requirement under which no applicant may be favorably considered who has not had two or three years of public practice.

This is a step in the right direction, but it is not sufficient. There should be a further requirement that the applicant who is to describe himself as a certified public accountant shall be actually engaged in public practice either on his own account or in the employ of another accountant.

To put the matter in another way, we may say that no one but a public accountant should ever be permitted to describe himself as one.

How perfectly ridiculous it seems to read the record of John Doe, bookkeeper for three years in Blank & Co.'s shoe store, certified public accountant. It makes the designation absolutely meaningless, for the intent of the word *public* has no bearing whatever on the case.

There are at the present time forty-seven states in the union having C. P. A. laws. New Mexico alone has not enacted legislation of this character. Some states have a fairly rigid practice requirement; some have a merely nominal practice requirement; some have none at all. On the time-worn theory that the strength

of a chain is that of its weakest link, we may consider that the C. P. A. certificate as a whole has no more value than the value of a certificate in a state with the most lax statutory provisions.

The average business man does not stop to inquire from what state a certificate emanates; nor does he greatly care whether that certificate was received after an examination or by virtue of an omnibus waiver. The fact that some state in the union has sufficiently esteemed the qualifications of John Doe to permit him to describe himself as a certified public accountant means to the man of business that John Doe is probably just as good a man as any other person who is entitled to describe himself as a certified public accountant.

This comment is not dictated by any desire to criticize in a destructive way the status of the certified public accountant. If our readers will stop to think they will remember that the American Institute of Accountants through its standard examination has done more to strengthen the administration of the certified public accountant laws than has been done by any other agency, state or national. Many of the so-called weak states and most of the states generally considered strong have adopted the examinations of the institute, and by that means the C. P. A. degree is approaching a standard, so far as the examinations are concerned. The institute, however, does not interfere, and has no right to interfere, in any question of qualifications of the candidates. In consequence, any state is at liberty to examine and if it so desires to certify any candidate, provided his qualifications are sufficient to meet the requirements of the law or regulations of the state concerned.

The purpose of our criticism is constructive. It seems to us that the time has come when all states in which there is legislation providing for the certification of accountants should so amend their laws or regulations as to make public practice a prerequisite of examination.

If such reform were brought about, the phrase certified public accountant would then have a meaning and every rightful holder of a C. P. A. certificate would find himself in a far stronger position than he can occupy under the present conditions.

Seymour Walton

The entire accounting profession will learn with profound sorrow of the death of Seymour Walton.

In the course of his long association with the accounting profession, Mr. Walton did more to raise the standards of accounting education and to stimulate the highest professional ethics than almost any other man of his time. His efforts were always directed to the upbuilding of higher and higher professional standards, and he labored indefatigably even during the last years of his life when his health was rapidly declining. Even on the day of his death he was engaged in answering accounting questions which had been brought to his attention.

The Journal of Accountancy suffers an almost irreparable loss in Mr. Walton's death. For six years he had been editor of *The Students' Department,* and had made of that department one of the most valuable portions of the magazine. Many a young practitioner, and probably many an elder one, has derived help of an invaluable kind from the clear and correct expositions of accounting theories and problems made by Mr. Walton in *The Students' Department.* (The copy for the July, August and September issues was prepared by Mr. Walton shortly before his death and his name will appear at the head of the *Students' Department* for those months.)

Seymour Walton was born in New Orleans, February 15, 1846, and was the son of John Stevenson Walton. He was educated at Williams College. Upon entering business he became the first cashier of the Fort Dearborn National bank of Chicago, which he had helped to organize. After enactment of C. P. A. legislation in Illinois, he became a certified public accountant, and was president of the Society of Certified Public Accountants of Illinois. He was vice-president of the Marquette club, dean of the Walton school of commerce, professor at Northwestern university, and later at Marquette university, editor of *The Students' Department of* The Journal of Accountancy, member of the Press club of Chicago, Sons of the American Revolution, Founders and Patriots' society and a member of the Lake View Presbyterian church.

Death occurred June 26th, at his residence, 550 Surf Street,

Chicago. Mr. Walton is survived by a widow and four children.

In recording the passing of this great friend of accountancy, The Journal of Accountancy takes the liberty of expressing for the entire profession the deepest sympathy with those who have been bereaved.

Income-tax Department

EDITED BY STEPHEN G. RUSK

Treasury decision 3017 apparently is intended to make the language more specific, in the application of the 1917 excess-profits-tax law, in the classification of the income of taxpayers as to whether or not the income was derived from the employment of capital in the business.

Under the revenue law of 1918 individuals and partnerships are not subject to excess-profits tax, and, therefore, this decision is not of the general interest it would be were the former law still in effect.

This decision, of course, will not be found to throw any additional light on the many moot questions of whether the capital employed in a trade or business is simply nominal or is essential to the functioning of the trade or business.

As the 1917 law was the first within recent years wherein the federal government laid a tax upon so-called excess profits, and as the law was complex in its structure, there was almost endless misapprehension as to the application of its various provisions; and perhaps none caused greater confusion than those provisions which sought to classify the income as between that derived from a trade or business having no invested capital, or not more than a nominal capital, and those in which invested capital was necessary.

It is a safe guess that a considerable proportion of the returns under the 1917 law were incorrectly made; and so any new light that is thrown on the provisions of that law should be of interest to accountants and their clients.

(T. D. 3017, May 3, 1920)

War-excess-profits tax

Amendment of articles 14, 15 and 16, regulations 41, relating to classification of rates according to trades or businesses

In order to remove misapprehensions which have arisen as to the meaning of articles 14, 15 and 16, regulations No. 41, these articles are hereby amended, in conformity with the construction uniformly placed thereon by the commissioner of internal revenue, to read as follows:

ART. 14. *Classification of trades or businesses.*—For the purposes of the excess profits tax trades or businesses which are subject to the tax shall be divided into two classes, as follows:

A. Trades or businesses having no invested capital or not more than a nominal capital, including, in the case of *individuals,* occupations in which they receive salaries, wages, fees, or other compensatons; and

B. Trades or businesses having more than a nominal capital.

In the case of a *corporation or partnership,* all the trades and businesses in which it is engaged shall be treated as a single trade or business (as provided in sec. 201), and all its income from whatever source derived shall be deemed to be received from such trade or business, and if in such trade

or business, considered as a unit, such corporation or partnership employs more than a nominal capital (whether invested, borrowed, or of any other character) it will not be entitled to be assessed under the provisions of section 209.

Inasmuch as all the trades or businesses in which a corporation or partnership is engaged are treated as one, a corporation or a partnership shall be allowed either the deduction provided for in section 203 or the deduction provided for in section 209 (depending on the character of its trade or business), but not both.

In the case of *an individual* each trade or business in which he is engaged, the net income from which is subject to the excess profits tax, shall be classified as provided in this article. Each trade or business in class A shall be taxed as provided in article 15, and each trade or business in class B shall be taxed as provided in article 16. If an individual is engaged in two or more trades or businesses, in one of which he employs more than a nominal capital (whether invested, borrowed, or of any other character), he will be assessed under the provisions of section 209 only as to those trades or businesses in which he employs no invested capital or not more than a nominal capital; and as to all others he will be assessed under section 201.

If an individual has more than one business with invested capital, they will all be regarded as one, and (under the provisions of sec. 203) only one deduction will be allowed; if he has more than one business with not more than a nominal capital, they will be regarded as one, and (under the provisions of sec. 209) only one deduction will be allowed. If he has both kinds of businesses he will be regarded as having two businesses and there will be two deductions, but not more than two. (See arts. 35 and 36, regulations No. 41.)

ART. 15. *Rate of tax on trades or businesses in class A.*—The tax upon trades or businesses in class A, as defined in article 14, shall be computed at the rate of 8 per cent upon the net income thereof in excess of $3,000 in the case of a *domestic corporation;* upon the net income thereof in excess of $6,000 in the case of a *domestic partnership* or of a *citizen* or *resident* of the United States; and upon the net income thereof without deduction in the case of a *foreign corporation or partnership* or of a *non-resident alien* individual.

ART. 16. *Rate of tax on trades or businesses in class B.*—The tax upon trades or businesses in class B, as defined in article 14, shall, except as otherwise provided in article 17, be computed at the following rates:

20 per cent of the amount of the net income in excess of the deduction (determined as provided in arts. 21, 23 and 24), and not in excess of 15 per cent of the invested capital for the taxable year;

25 per cent of the amount of the net income in excess of 15 per cent and not in excess of 20 per cent of such capital;

35 per cent of the amount of the net income in excess of 20 per cent and not in excess of 25 per cent of such capital;

45 per cent of the amount of the net income in excess of 25 per cent and not in excess of 33 per cent of such capital;

60 per cent of the amount of the net income in excess of 33 per cent of such capital.

(The illustrations given in par. 28 of regulations No. 41 remain without change.)

Treasury decision 3018, "concerning interest coupons presented without ownership certificates," is self-explanatory and is interesting to those having to do with withholding taxes at the source.

(T. D. 3018, May 18, 1920)

Income tax

Amending article 368, final edition of regulations 45, concerning interest coupons presented without ownership certificates

The final edition of regulations 45 is amended by changing article 368 to read as follows:

ART. 368. *Interest coupons without ownership certificates.*—When interest coupons are received unaccompanied by certificates of ownership, the first bank shall require of the payee an affidavit showing the name and address of the payee, the name and address of the debtor corporation, the date of the maturity of the interest, the name and address of the person from whom the coupons were received, the amount of the interest, and a statement that the owner of the bonds is unknown to the payee. Such affidavit shall be forwarded to the collector with the monthly return on form 1012 (revised). The first bank receiving such coupons shall also prepare a certificate on form 1000 (revised), crossing out "owner" and inserting "payee," and entering the amount of interest on line 6, and shall stamp or write across the face of the certificate "affidavit furnished," adding the name of the bank.

The following treasury decision with respect to premiums on business insurance throws some additional light on the question as to when the proceeds of such insurance policies become taxable income.

(T. D. 3019, May 18, 1920)

Income tax

Items not deductible; article 294, regulations 45, amended

Article 294 of regulations No. 45 is hereby amended to read as follows:

ART. 294. *Premiums on business insurance.*—Premiums paid by a taxpayer on an insurance policy on the life of an officer, employee, or other individual financially interested in the taxpayer's business, for the purpose of protecting the taxpayer from loss in the event of the death of the officer or employee insured, are not deductible from the taxpayer's gross income. If, however, the taxpayer is in no sense a beneficiary under such a policy, except as he may derive benefit from the increased efficiency of the officer or employee, premiums so paid are allowable deductions. (See arts. 33 and 105 to 108.) In either case the proceeds of such policies paid upon the death of the insured may be excluded from gross income if the beneficiary is an individual, but must be included in gross income if the beneficiary is a corporation. (See sec. 213 (b) (1) and arts. 72 and 541.

The matter contained in treasury decision 3024 is new. The rules laid down in article 1585 of regulations 45 prescribed the accepted manner in which dealers in securities should inventory their stock in trade, but were silent on the subject of lumber or other commodity inventories.

This treasury decision is of interest as a method of inventorying, not only lumber, in its initial transformation from the logs, but also other natural resources. It would seem that the same rule would apply satisfactorily to the inventorying of coal and ore of various kinds.

(T. D. 3024, June 2, 1920)

Income tax

Inventories of lumber manufacturers

Regulations No. 45 are hereby amended by inserting after article 1585 (a) a paragraph to be known as article 1585 (b), reading as follows:

Art. 1585 (b). *Inventories of lumber manufacturers.*—1. Because of the impracticability of determining accurately the costs properly assignable to each species, grade and dimension of lumber making up the product of the mill, lumber manufacturers may use as a basis for pricing inventories the average cost to the manufacturer of producing the inventoried products during the taxable year for which the return of net income is made.

2. If the quantity of lumber on hand at the time of inventory is greater than the total quantity of lumber produced during the current taxable year, it is evident that the excess stock has been carried over from the previous year's production, and such excess shall be valued at the average cost of production for the preceding taxable year.

3. A taxpayer who regularly allocates in his books of account such average cost to the different kinds and grades of lumber in proportion to the selling value of such kinds and grades may, subject in each case to the approval of the commissioner upon the audit of the return, make his returns of net income on that basis.

4. The term lumber manufacturer, as used in this article, means a person who manufactures lumber from logs, as distinguished from a remanufacturer of lumber.

The following recommendations and office decisions cover a varied field of interest to those of the accountancy profession who give their attention to income and profits tax matters.

Those rulings which are indicated by the letters "A. R. R." represent recommendations by the board of appeals and review of the treasury department.

Those indicated by the letters "O. D." represent offices decisions made by the department of internal revenue. These recommendations and decisions cover a number of subjects, among which are consolidated returns and the basis for determining the gain or loss upon the sale of certain railway stock.

SECTION 202—BASIS FOR DETERMINING GAIN OR LOSS

Section 202, Article 1568: Determination of gain or loss from subsequent sale. — 22-20-967 A. R. R. 126

Revenue act of 1917

In re the appeal of A from the action of the unit in holding that profit was realized by him upon the sale of certain railroad stock which he owned.

The committee has had under consideration the appeal of A from a ruling of the income-tax unit holding that profit was realized by the taxpayer upon the sale of certain railroad stock owned by him.

The facts appear to be that the taxpayer individually built and owned a railroad which was constructed for the sole purpose of carrying the product of the taxpayer's mills to stations on other roads for distribution. The state railroad commission required the incorporation of this road, which was done in 1914. The appraised value of the property as of March 1, 1913, was $30x$ dollars, the cost of additions between that date and the date of incor-

poration being $12x$ dollars, making a total of $42x$ dollars. Against this amount bonds were issued to the amount of $20x$ dollars, the total proceeds being received by A, reducing his investment on the above basis to $22x$ dollars. Against this the commission permitted the issuance of stock in the amount of $30x$ dollars. The taxpayer now contends that at the time of incorporation the property was worth the $30x$ dollars for which it was incorporated, and that profit, if any, was made in 1914 at the time of incorporation, and a loss suffered when the stock of the railroad was sold in 1917 for $27x$ dollars.

The unit has ignored the possibility of accretion in value of these assets between March 1, 1913, and the date of incorporation. Whatever accretion there may have been in these values would clearly, under the rulings of the office, be taxable profit when converted into stock of the corporation, since the stock would be deemed to be at least equal in value to the assets behind it.

It is further contended by the taxpayer that under numerous decisions of the office where property is exchanged for stock the stock will be deemed to be worth its par value in the absence of evidence to the contrary. Had there been no appraisal of the property, the committee is of the opinion that this position would have been well taken, and that the burden of proof would have been on the government to show that the stock was worth less than its par value had the taxpayer claimed it to be of value equal to or greater than par. However, the appraisal about that time appears to establish that the property turned over to the corporation was worth less than the par value of the stock received. Undoubtedly that appraisal would have been recognized by the unit in 1914 as establishing the fact that no profit was then realized by the taxpayer had he presented such claim during that year.

The committee is therefore of the opinion that in the absence of evidence conclusively proving that at the time the property was turned over to the corporation in 1914 it was of greater value than indicated by the appraisal as of March 1, 1913, no profit can be deemed to have been made in 1914, and consequently that the difference between the value of the stock at that time so determined and the sale price of 1917 is taxable profit in the latter year.

SECTION 213(b)—GROSS INCOME DEFINED: EXCLUSIONS

Section 213(b), Article 85: Compensation of state officers. 20-20-968
O. D. 525

A referee in drainage is appointed by the district judge of the state judicial district in which the drainage project is located. The judge is vested with authority to provide for the payment of the referee's salary, to regulate his duties, and to discharge him at pleasure.

Held that the referee is an employee of a political subdivision of the state, and that his salary as such is not subject to tax under the revenue act of 1918.

SECTION 214(a), 4, 5, 6.—DEDUCTIONS ALLOWED: LOSSES

22-20-968
O. D. 526

A ring was lost by its owner, and owing to the circumstances attending the loss he is in doubt as to whether it was stolen or merely misplaced or lost from his finger.

Unless he can establish the fact that the ring was stolen no deduction can be allowed on account of the loss.

Such a loss does not come within the meaning of the term "other casualty" as used in section 214(a) 6 of the revenue act of 1918. This term embraces losses arising through the action of natural physical forces and which occur suddenly, unexpectedly, and without design of the one suffering the loss.

SECTION 214 (a) 10—DEDUCTIONS ALLOWED: DEPLETION

Section 214(a), 10, Article 220(a): Discovery—Proven tract or lease—Property disproportionate value. (Also article 220.) 22-20-970 O. D. 527

1. In determining the market value, for depletion purposes, of "property" upon which oil or gas wells have been discovered since March 1, 1913, the "private bounding lines," mentioned in article 220(a) 3, refer to the *exterior limit of a continuous tract held under lease or leases or in fee by the taxpayer.* To illustrate:

The X company has leases upon the S. E. quarter of the N. W. quarter of section 10. The X company holds this land under five separate leases from different fee owners. A well is brought in upon the land, conceded to be a discovery well, subsequent to the acquiring of the leases by the company, and so located as to include the entire 40 acres of X company in the proven area. The property to be valued is the drill hole, the surface necessary for the drilling and operation of the well, the oil or gas content of this particular sand, zone, or reservoir, in which the discovery was made, to the limits of the entire 40 acres held by X company. If the "private bounding lines" in article 220(a) 3 were interpreted to mean the boundaries of each lease, it would enable the X company to value one well subsequently brought in upon each of the five leases, and such a result would be contrary to the purpose of article 220.

2. Wells drilled upon a proven tract which has already been valued under the provisions of section 214(a) 10 of the act, have no significance upon the value previously given the "property." But wells brought in upon a proven area still further extend the proven area. To illustrate:

The A company owns an acreage of land upon which a discovery well is brought in, all of the proven area being included in the acreage. The A company, for the purpose of ascertaining allowable deductions for depletion, determines the fair market value of the "well," i. e. (1) the drill hole, (2) the surface necessary for the drilling and operation of the well, and (3) the oil or gas content of the particular sand, zone or reservoir, in which the discovery was made by the drilling, and from which the production is drawn. The great increase in value, of course, is from item (3), the oil or gas content of the sand, zone or reservoir. If the A company were allowed to value other wells brought in upon this proven area, it would in fact be valuing the same oil and gas content of the sand, zone or reservoir, which had previously been valued and upon which depletion was being taken. Such a result would be distinctly contrary to the theory of income taxation and the purpose of article 220. However, the bringing in of other wells upon this proven area still further extends the proven area to the extent provided in article 220, and wells brought in upon an area so proven cannot be revalued unless the land was acquired before proven.

3. If a well should be drilled in the corner of a quarter section of land owned by the taxpayer, to be able to value the portion of the quarter section not proven by the well, it would be necessary for other wells to be brought in upon the area not proven by the first well.

SECTION 231.—CONDITIONAL AND OTHER EXEMPTIONS

Section 231, Article 513: Mutual savings banks. 22-20-974 O. D. 528

A savings fund association has no capital stock represented by shares and derives its entire income from investments of deposits, the income being divided pro rata among all the members after deducting operating expenses. The members who are required to be depositors elect the board of trustees from their number and these trustees in turn elect officers.

Held, that this association is exempt from taxation as a mutual savings bank not having capital stock represented by shares as provided by section 231(2) of the revenue act of 1918.

Section 231, Article 517: Religious, charitable, scientific and educational corporations.

(See 22-20-971; sec. 214(a) 11, art. 251.) Corporation engaged in disseminating propaganda to encourage labor legislation.

SECTION 234—DEDUCTIONS ALLOWED: CORPORATIONS

Section 234, Article 561: Allowable deductions. 22-20-975 O. D. 529

Payments to trustees by a cemetery corporation during the taxable year of a certain percentage of the proceeds of sales of cemetery lots set aside for a maintenance fund to be controlled solely by the trustees thereof are not deductible from the gross income of the corporation even though such payments are required by state law.

SECTION 240—CONSOLIDATED RETURNS

Section 240, Article 633: When corporations are affiliated. 22-20-976 A. R. R. 123

Recommended that the decision of the income-tax unit, holding that the M company and the N company are not to be deemed affiliated with the O company within the meaning of the law, be sustained.

The committee has had under consideration the appeal of the O company from a ruling of the income-tax unit to the effect that the consolidated return of said company may not include invested capital nor income of the M company and the N company.

The facts relating to the connection of these two companies with the O company appear to be that the stock of the N company is wholly owned by persons not related to the O company, and that the stock of the M company was similarly owned by outsiders until the date upon which it became affiliated with the O company, from which time the unit concedes that the income and invested capital should be included in the consolidated return.

The grounds on which the O company urges the inclusion of these two companies in its consolidated return are based upon contracts made with the several companies under which the M and N companies assemble or manufacture machines from parts furnished by the O company at cost to it, or through it with the various subsidiaries and others with which it has contracts. Under the terms of the contract in the case of the M company the O company is to be entitled to 60 per cent of the net profits, and in the case of the N company 50 per cent of the net profits of the respective corporations. The returns of these two companies were included in the consolidated return of the O company for 1917.

In regulations 41, covering 1917, it was held that—

For the purpose of this regulation two or more corporations will be deemed to be affiliated (1) when one such corporation owns directly or controls through closely affiliated interests or by a nominee or nominees, all or substantially all of the stock of the other or others, or when substantially all of the stock of two or more corporations is owned by the same individual or partnership, and both or all of such corporations are engaged in the same or a closely related business; or (2) when one such corporation (a) buys from or sells to another products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or (b) in any way so arranges its financial relationship with another cor-

poration as to assign to it a disproportionate share of net income or invested capital.

The permission to consolidate in 1917 appears to have been based on the provisions of paragraph (2) above. It will be noted that this paragraph is not carried into section 240 of the 1918 law, which holds, in paragraph (b), that—

For the purpose of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests.

Thus it will be seen that under the 1918 law, in order that corporations may be deemed to be affiliated there must be an ownership or control by one corporation, such as contemplated by the statute, of substantially all of the stock of one or more other corporations, or substantially all of the stock of two or more corporations must be owned or controlled by the same interests. It is believed that it was not the purpose of the 1918 act to class corporations as affiliated merely because of the commercial or financial relations existing between them when there was no stock ownership or stock control of the character and extent prescribed by the statute.

Since the element of stock ownership or stock control is not sufficiently established by the facts presented in this case the committee reaches the conclusion that the decision of the unit that the M company and the N company are not to be deemed affiliated with the O company within the meaning of the law is correct, and recommends that its action be sustained.

SECTION 250—PAYMENT OF TAXES

Section 250, Article 1004: Penalty for failure to file return.

(See 22-20-977; sec. 253, art. 1041.) Penalties not asserted in case of delinquent returns for 1914 filed after expiration of three-year period of limitation.

SECTION 253—PENALTIES

Section 253, Article 1041: Specific penalties. (Also section 250, article 1004.) — 22-20-977, O. D. 530

ACT OF 1913

Where delinquent individual returns for the taxable year 1914 have been filed after the expiration of the three-year period of limitation, specific and ad valorem penalties will not be asserted. If the taxpayers signed the delinquent returns it will not be necessary to secure waivers for the purpose of assessing the taxes.

SECTION 257—RETURNS TO BE PUBLIC RECORDS

Section 257, Article 1091: Inspection of returns. — 22-20 978, O. D. 531

In accordance with section 257 of the revenue act of 1918 lists containing the names and postoffice addresses of individuals making income-tax returns to collectors are posted for public inspection in the public corridors of collectors' offices and postoffices. Persons will not be allowed to enter the workrooms of collectors' offices either outside or during office hours for the purpose of making copies of such lists.

SECTION 301—IMPOSITION OF TAX

Section 301, Article 714: Computation of tax on income from government contracts. 22-20-979 O. D. 532

In 1919 a corporation derived a profit in excess of $10,000 from government contracts, but sustained a net loss on other operations. Held that it may deduct the amount of such loss in ascertaining its net income subject to tax. If the amount of the excess-profits credits exceeds the company's total net income from all sources for 1919 no tax will be imposed upon the portion of its net income for that year which was derived from government contracts.

Since the company's net income included an item of net profit from government contracts in excess of $10,000, it will be required to supply fully all of the data called for by the supporting schedules of form 1128-S.

Missouri Society of Certified Public Accountants

The annual meeting of the Missouri Society of Certified Public Accountants was held in St. Louis, June 11, 1920. The following officers were elected for the ensuing year: President, Edward Fraser, Kansas City; first vice-president, Victor Stempf, St. Louis; second vice-president, A. G. Saxer, St. Louis; secretary, F. A. Wright, Kansas City; treasurer, E. H. Wagner, St. Louis; directors, F. A. Smith, Kansas City; F. C. Belser, St. Louis; F. H. O'Connell, St. Louis.

There were thirty members of the society in attendance at the business meeting and about forty present at the banquet held in the evening at the Glen Echo country club. At the morning meeting F. A. Thornton, of St. Louis university, spoke on the *"Economic Trend of the Day."*

Delaware Society of Certified Public Accountants

At the annual meeting of the Delaware Society of Certified Public Accountants, June 8, 1920, the following officers were elected: President, Will-A. Clader; vice-president, William H. Van Hekle; secretary, Clifford E. Iszard; treasurer, Peter T. Wright. All the officers and T. Whitney Iszard were elected members of the executive committee.

Society of Incorporated Accountants and Auditors

The council of the British Society of Incorporated Accountants and Auditors has unanimously elected William Claridge president and George Stanhope Pitt vice-president of the society for the ensuing year.

Marwick, Mitchell & Co. announce the opening of offices in the Kenyon building, Louisville, Kentucky, under the management of R. W. Barton, and in the Kennedy building, Tulsa, Oklahoma, under the management of W. G. Haitch.

Richter & Co. announce the opening of offices in Farmers Bank building, Pittsburgh, Pennsylvania.

Students' Department

EDITED BY SEYMOUR WALTON

(ASSISTED BY H. A. FINNEY)

AMERICAN INSTITUTE EXAMINATION, MAY, 1920

In regard to the following attempt to present the correct answers to the questions asked in the examination held by the American Institute of Accountants in May, 1920, the reader is cautioned against accepting the answers as official. They have not been seen by the examiners—still less endorsed by them.

AUDITING

Answer any ten of the following questions:

Question No. 1:

In auditing the accounts of a co-partnership you find that the real estate account includes two pieces of property, the titles to which stand in the names of individual partners. What position would you take in regard to such items?

Answer to Question No. 1:

I would not certify any balance-sheet unless all the assets were under the full control of the firm and not subject to the will of any individual partner, as is the case here. I would require that the condition be corrected.

A partnership is not a legal entity and cannot hold legal title to real estate; it can have equitable title, the legal title usually being held by one or more partners in trust for the partnership.

This equitable title may be shown by the articles of partnership if they recite the fact that the individuals hold title in trust for the firm, but the rights of the partnership should be safeguarded against a purchaser to whom the individual legal owner may attempt to give title. If the partnership were occupying the property or exercising ownership over it, a prospective purchaser would be charged with notice of this fact, and he would take title subject to the rights of the partnership.

A sale in such circumstances by the individual holding title would involve the partnership in a legal controversy, and it would be advisable for the partnership to obtain from the individual a statement that he is holding the property in trust, and have this statement recorded.

The highest form of protection would be obtained by having the individual owner quit-claim the undivided interests to the other partners.

Question No. 2:

You have been retained by a manufacturing company as a consulting accountant, and are requested to advise the officers what steps to take in order to determine the cause of an apparent deficiency in the inventory of factory material and work in process. How would you proceed to inform

yourself of the circumstances and what would you suggest as a possible remedy?

Answer to Question No. 2:

If only a physical inventory is taken it is difficult to see how a deficiency would become apparent, and it is therefore assumed that the question means that a perpetual inventory is maintained, and that the physical inventory shows less material and goods in process than the running inventory. The possible causes and sources of information are:

1. Over-issues. More goods may have been issued than were required for the factory orders. A number of filled requisitions should be examined and checked back to the factory orders to see if the amount of goods called for on the requisitions is greater than that which would actually be required on the factory orders. It might be possible that the storekeeper had issued more goods than the requisitions required—this would be very difficult to ascertain, but it might be worth while to make inquiry of the foremen and superintendent.

2. Short receipts. It would be desirable to check back some invoices to the stores ledger to see whether more goods were charged into the stock records than were actually received. It is possible that some information might be obtained by questioning the receiving clerk and the stores clerk.

3. Clerical errors. A comprehensive check of receiving reports and requisitions against the stores ledger should be made, as well as checking the computation of the balances.

4. Thievery. The system of stores controls should be investigated to see whether anyone besides the storekeeper has access to the stock. There should be no laxness in giving out extra material on the claim that the original issued was spoiled, unless the request for additional material is supported by a requisition.

By way of remedy, an adequate system safeguarding issues and receipts should be inaugurated. When goods are received, the receiving clerk should be provided with a receiving report which does not show the quantities ordered; on this report he should enter the quantities which he actually receives, and this report, after having been compared with the invoice and purchase orders, should be made the basis of the charge in the stores ledger. No stores should be issued except upon written requisition signed by some responsible officer in the factory. To detect clerical errors a controlling account should be kept on the general ledger, charged with all receipts and credited with all issues, so that the balance would represent the sum of the balances of the stores ledger. The work of the stores ledger keeper and the general ledger keeper would thus serve as a check against each other. Thievery would become difficult if no one except the storekeeper had access to the stores and if requisitions for material were not valid unless signed by a responsible officer. Test inventories of various portions of the stock should be made frequently throughout the year, so that any discrepancies will be found at once. These test inventories should be arranged so that the entire stock will be covered at least twice a year.

Of course there is a possibility that the physical inventory itself may be wrong, but the periodical part inventories taken throughout the year should be re-checked if discrepancies appear.

As to work in process a physical inventory would be difficult to value, and the only accurate basis for the inventory lies in the production orders of unfinished goods. Tests should be made to see that they are supported by material requisitions and labor reports and that the rate of overhead is correct. An inspection of the factory should be made to see that there actually are jobs in process corresponding to the production orders. It is possible that a workman may spoil material and throw it away without reporting it. If new material is requisitioned and charged to work in process the inventory will be inflated. But with a proper system of requisitions, a reason for issuing new material would be shown and the cost of the spoiled work would be credited to the goods in process.

Question No. 3:

Give some reasons why the professional auditor should, under present-day conditions, give even more attention than in the past to (a) inventories, (b) insurance carried, (c) bank balances in foreign countries.

Answer to Question No. 3:

(a) Inventories should be scrutinized with especial care because of the phenomenal conditions in regard to prices. Many things have risen so much in market value that the temptation is strong to inventory at much more than cost things which were bought some time ago at what now seem very low prices. There is no certainty that the present high prices will continue; on the contrary the indications in many lines are that a decided drop in prices may soon take place.

(b) Although the increase in market prices over cost must not be reflected in the inventory valuations, it must be considered in the insurance carried. Insurance is based on replacement value, regardless of cost, so that goods may be insured for much more than the value placed on them in the inventory.

(c) Rates of exchange on foreign countries are now so abnormal that no dependence can be placed on them. Large balances might almost be looked upon with suspicion, and perhaps a reserve might be set up against them, although at present it looks as if foreign balances would increase rather than decrease in value.

Question No. 4:

The machinery used by a firm has been purchased on the instalment plan, with monthly payments, and under the stipulation that title shall not pass until the last payment has been made. At the close of the year there are several payments yet to be made. The firm also pays a royalty on the output of some of the machines secured on this plan. How should the accountant in the annual statement deal with (a) the machinery, (b) the instalments paid, (c) the royalties?

Answer to Question No. 4:

The balance-sheet should show the contract cost of the machinery, the

unpaid instalments, the depreciation reserve and any accrued or deferred interest.

If the contract called for the payment of periodical instalments and also for interest on the unpaid balance of the contract, there might be accrued interest to be shown as a liability. In this case the condition would be shown thus:

Fixed assets:		
Machinery under purchase contract....	$ Contract price	
Less depreciation	$	
Carrying value		$
Less liability under contract:		
Vendor—machinery purchase contr't.	$ Unpaid instalments	
Accrued interest	$	$
Carrying value of equity.............		$

The unpaid instalments and the accrued interest are both deducted from the carrying value of the asset, because they are both secured by the property.

When the machinery is quoted at a cash price and also at a larger instalment price, the difference between the prices is, so far as the vendee is concerned, interest paid for the instalment privilege. The entry, when making the contract, should be:

Machinery under purchase contract......	Cash price	
Deferred interest—machinery contract...	Difference	
Vendor—machinery purchase contract..		Instalment price

Each month, when a payment is made, the vendor account would be charged with the total payment, and a portion of the interest, computed by the bonds-outstanding method, would be charged to interest and credited to deferred interest—machinery contract. Under such conditions the balance-sheet would show:

Fixed assets:		
Machinery under purchase contract....	$ Cash price	
Less depreciation	$	
Carrying value		$
Less liability under contract:		
Vendor—machinery purchase contr't.	$ Unpaid instalments	
Less liability for deferred interest.....	$	$
Carrying value of equity.............		$

There might also be accrued royalties, in which case they should be shown as an accrued current item on the liability side of the balance-sheet.

The cost of the asset is shown as machinery under purchase contract, because this property should not be charged to the regular machinery account until title is acquired. The special terminology, vendor—machinery purchase contract, is used to distinguish this liability from those due to trade creditors.

The profit and loss statement should show the depreciation on the machinery, the interest on the deferred instalments and the royalty. The depreciation should be based on the total cost of the machinery and not on the equity, and it should be shown as a manufacturing expense. The interest should be shown as a financial expense. If output, as used in the question, means quantity manufactured, the royalty is paid for the right to use the machinery in manufacturing, and it should be shown as a manufacturing expense. If output means quantity sold, the royalty is not incurred by manufacture but by sale, and it should be shown as a selling expense.

Question No. 5:

Discuss the principles under which the calculation of charges in a mining company should be made, covering (a) depreciation of plant and equipment, (b) amortization of development expenses.

Answer to Question No. 5:

Theoretically the depreciation of mine plant and equipment and the amortization of development expense should be based on the total cost less the estimated salvage. For income-tax purposes this is subject to the modification that the total charge may be "based (a) upon cost, if acquired after February 28, 1913, or (b) upon the fair market value as of March 1, 1913, if acquired prior thereto, or (c) upon the fair market value within thirty days after the date of discovery in the case of mines * * * * discovered by the taxpayer after February 28, 1913, where the fair market value is materially disproportionate to the cost."

The annual charges for depreciation may be based on depletion of the ore body or on the estimated life of the plant and equipment, regardless of the depletion of the ore body. The development expenses should be amortized on the basis of depletion.

Question No. 6:

You have been called to audit the books of a furniture company which sells on the instalment plan. The books have been closed when you reach the office, and you are handed a completed profit and loss account and balance-sheet. The company has been in business one year only.

On investigation you find that all instalment sales are credited to an account designated "instalment sales." A controlling account and subledger are kept for the instalment customers.

You find that the total of the instalment sales has been credited to instalment sales account, which has been closed into profit and loss.

All accounts, instalment and otherwise, that were known to be uncollectible have been charged off. There are no reserves against balances due from customers on the books.

What criticisms or corrections have you to suggest as to the correctness or otherwise of the balance-sheet and profit and loss statement handed to you?

Answer to Question No. 6:

Theoretically the year just closed should receive credit for the profit on all of its instalment sales, with deductions for ascertained bad debts written off, for estimated future loss on accounts receivable, and for collection expense to be incurred in future years in collecting accounts put on the books during the past year. This would necessitate setting up two reserves: one for bad debts and another for collection expense.

From a practical standpoint the setting up of proper reserves would be very difficult, particularly in the case of a business which had been in operation only one year, as there are no experience figures on which to base the estimates. Therefore, it would probably be desirable to take up the profits in accordance with the method sanctioned by the income-tax regulations, by taking "that proportion of the total payments received in the taxable year from instalment sales which the gross profit to be realized on the instalment sales made during the taxable year bears to the gross contract price of all such sales." In addition, the profits should include the collections made on accounts which proved worthless and were written off, with a deduction of the loss on or damage to recovered property.

If this plan is adopted a credit balance will be carried forward from the sales account, serving as a reserve against the accounts receivable, and the profit and loss statement will show profits reduced by the proportion of the gross profit applicable to uncollected instalment accounts receivable.

Question No. 7:

You find the following certificate appended to a balance-sheet:

"May 15, 1920. The foregoing balance-sheet is in accordance with the books of the A. B. C. Co.

"(Signed) John Smith, auditor."

State what, in your opinion, are the limitations, if any, of such a certification. Assuming you were afforded all reasonable facilities for the conduct of an audit of the company, is it such a certificate as you would use? State definitely how you would amplify it.

Answer to Question No. 7:

This is not at all satisfactory, as the books, while mechanically correct, may not contain all the information that is obtainable, or may contain that information in a shape that is misleading. It is the duty of the auditor to obtain all the information that is possible in regard to the course and the condition of the business, and to make up his own exhibits, embodying that information. In his report he may show the profit and loss and the balance-sheet, as shown by the books, and follow them with similar tables, "as prepared by the accountant." He should add tables explaining the discrepancies between the exhibits he has prepared and those taken from the books, so as to justify his own figures, and also to serve as guides for those who may come after him. The most prolific source of difference will usually be the inclusion of items in the current year's operations that really belong to the previous or the subsequent year, or the omission of items that belong in the current year, although they may have appeared on the books before or after it.

I would not amplify it at all, unless the books themselves were absolutely correct, both as to contents and methods, in which case I would add "which have been thoroughly audited by me and found to be correct in every particular." Otherwise I would prepare my own statements and make my certificate with the facts as I found them.

Question No. 8:

The charter of a corporation which you are auditing contains a provision for the payment of an amount equal to 3 per cent of the preferred capital stock, originally issued, into a sinking fund. This fund, it is directed, is to be utilized in purchase of stock, at not exceeding 10 per cent premium, and its cancellation and retiral. State in full detail how you would reflect transactions under this provision in your balance-sheet. Give illustrations (a) assuming stock acquired at a discount of 10 per cent and (b) assuming stock acquired at a premium of 10 per cent.

Answer to Question No. 8:

When the contributions are made to the fund, a debit should be made to sinking fund for preferred stock retiral and a credit to cash. A true sinking fund should accumulate at compound interest for the purpose of paying off a positive liability at its maturity. As preferred stock has no maturity, it might be better to call the fund a preferred stock redemption fund; however, as the meaning is clear, the terminology of the charter is used.

If stock is acquired at a discount of 10 per cent the entry would be:

Capital stock preferred	Par	
Surplus		10% of par
Sinking fund for preferred stock retiral		90% "

The charge is made to the capital stock account instead of to treasury stock, because the stock is to be cancelled and retired. It might be necessary to carry it as treasury stock until permission was received from the state to reduce the authorized issue; but if the charter calls for the retiral of the stock it would seem to imply the sanctioning of its retirement.

If the stock were to be held in the treasury instead of cancelled, the credit of 10 per cent would be made to contingent profit on stock instead of to surplus, pending the realization of the profit by resale. But when the stock is to be cancelled there is no contingency: the transaction results in an immediate increase in the capital interest of the other stockholders.

If stock is acquired at 10 per cent premium, the entry would be:

Capital stock preferred	Par	
Surplus	10% of par	
Sinking fund for preferred stock retiral		110% of par

The fund would be shown on the asset side under the heading of investments. The preferred stock would be shown at the net amount outstanding. There would be no necessity for a reserve.

Question No. 9:

In auditing department store A, you find that cash discounts on purchases are regularly deducted from invoices when they are entered in the books, while in store B the invoices are entered in full and the discounts are

credited to a discount account as and when received. Discuss the relative advantages and disadvantages of the two methods, and state what variations, if any, would occur in the valuing of inventories under the two methods.

Answer to Question No. 9:

The question says that the cash discounts are deducted from the invoices when they are entered in the books. This may mean that

(A) They are deducted from the invoice and that purchases will be charged and accounts payable credited net. If this is the case, there is no record of the amount of discounts earned. Therefore the concern cannot choose to treat the discounts as a financial earning, but is compelled to treat them as a deduction from the cost of purchases.

(B) They are deducted only from the credit to accounts payable, purchases being charged gross, the offsetting credits being made to accounts payable and purchase discount. This gives a record of the total discounts available, and the concern still has a choice of treating the discount as a financial earning or a deduction from cost. When a bill is paid too late to get the discount, discounts lost should be charged. A decided advantage is thus gained, as the purchase discount account shows the possible saving, the discounts lost shows the amount forfeited, and the difference between the two accounts shows the net amount taken. Of course an adjustment must be made at the time of closing the books for entered discounts on unpaid bills.

(C) The discounts are not entered until the bills are paid. In that event the books show the full liability on accounts payable, but the available discounts, the discounts lost and the net amount taken are not shown.

As to the valuation of the inventory, in case (A) the concern is obliged to treat the discount as a deduction from purchases, and it should also value the inventory net. In cases (B) and (C) it may choose. If it treats the discount as a deduction from cost, it should value the inventory net. If it treats the discount as a financial earning it should value the inventory gross. Any other treatment would have a marked effect on the showing of net profits, particularly if any considerable portion of the purchases remained in the inventory.

By way of illustration let us assume that during the first year of the life of a concern its purchases amounted to $100,000, it took $2,000 cash discount on these purchases and it sold half of these goods for $75,000. Assuming that this concern treats the cash discount as a deduction from the purchases, the following incomplete profit and loss statements show the result of a consistent treatment and an inconsistent treatment of the cash discount.

	Consistent treatment		Inconsistent treatment	
Sales		.... $75,000.00		.... $75,000.00
Deduct cost of goods sold:				
Purchases—gross cost..	$100,000.00	....	$100,000.00	....
Less cash discounts....	2,000.00	....	2,000.00	....
Net cost of purcha's.	$98,000.00	....	$98,000.00	....

	Consistent treatment		Inconsistent treatment	
Less inventory (½ of purchases)	49,000,00	....	50,000.00	....
Cost of sales........		49,000.00		48,000.00
Gross profit	....	$26,000.00	....	$27,000.00

Since this concern considers that the discount reduces the cost of the purchases, it is not justified in considering that it has earned the entire $2,000 of cash discount until it has sold all the goods. For this reason it can consistently show a gross profit of only $26,000.

On the other hand, assuming that the concern treats the cash discount as a financial earning, it is entitled to show that it has sold goods costing $50,000 and made a gross profit thereon of $25,000, in addition to which it has made a financial earning of $2,000. The inconsistent treatment deprives it of $1,000 of profit which it might legitimately show.

	Consistent treatment		Inconsistent treatment	
Sales	....	$75,000.00	....	$75,000.00
Deduct cost of goods sold:				
Purchases	$100,000.00	....	$100,000.00	....
Less inventory	50,000.00	....	49,000.00	....
Cost of sales........		50,000.00	....	51,000.00
Gross profit...............	....	$25,000.00	....	$24,000.00
Add sales discounts........	....	2,000.00	....	2,000.00
Gross profit................	....	$27,000.00	....	$26,000.00

Question No. 10:

In a manufacturing concern which you are requested to audit, you find that what appears to be a careful book inventory of raw materials, supplies and work in process is maintained, but no physical inventory has been made for some years. Would you consider this a satisfactory state of affairs? And, if so, on what safeguards would you insist to insure constant accuracy in the records?

Answer to Question No. 10:

This is certainly not a satisfactory state of affairs.

The wording of this question is somewhat entangling. If the applicant answers that it is a satisfactory state of affairs he is required to say upon what safeguard he would insist. If he answers that it is not a satisfactory state of affairs, it does not appear that he is required to answer the last part of the question and give a remedy.

As we do not consider it a satisfactory state of affairs we are presuming to go a step farther than the examiners require and suggest a remedy. The system suggested in the answer to the second question should be employed,

including control over receipts and issues. This should be supplemented by periodical inventories of portions of the stock.

Question No. 11:

Outline a programme for a balance-sheet audit with a test of operations for any one of the following:

(A) A coal mining company.
(B) A coffee or rubber plantation.
(C) An import and export house with foreign connections.
(D) A suburban real-estate development company.

Answer to Question No. 11:

The space at our command will allow us to take up only the peculiar features of each of these cases. The object of a balance-sheet audit is to verify the correctness of the assets and liabilities, with only enough inquiry into the profit and loss methods to make sure that the amount of the surplus as stated is correct.

(A) Great care should be taken to see that payments have not been charged to the fixed asset account "mine" which are really royalties or other operating expenses. If the mine is operated on a rolalty basis with a minimum annual charge, only the excess of the minimum over royalties on coal actually mined, that it is expected will be later recouped, should be carried even as a deferred asset.

Only land, plant and equipment which are in present use or are held for future development should be included as assets.

Sufficient reserves should be established to cover all capital expenditures when the coal body is exhausted. The auditor should be especially careful to see that all mortgages are thus covered.

If the land is owned by the company and part of it is being operated to produce coal while other parts are being developed with new shafts and new equipment, it may be difficult for the auditor to determine whether the proper distinction has been made in charging expenditures as between capital and revenue. If he has had much experience in mining work he can make a very fair estimate, and that may be the best he can do.

(B) It is assumed that the audit is made of the company in the United States and not at the plantation itself. In either event the difficulty usually encountered is that of getting the proper reports from the plantation manager, especially if new land is being brought into cultivation at the same time that old land is being operated for a profit. The manager will nearly always claim that it is impossible for him to keep track of what labor goes on the new and on the old land. The best he will do is to estimate how much labor is required to grow the crop.

The crops of the different years must be kept separate. At the time of making the audit there will be considerable expense that has been put into the crop for the succeeding fiscal year. This is carried forward as a deferred charge, together with whatever proportion of the overhead is proper. The auditor will find use for considerable skill in determining how much can thus be carried forward.

As such a plantation would probably be situated in a country whose cur-

rency is different from ours, the auditor should remember that fixed assets are valued at the rate of exchange when they were acquired, while floating assets are valued at the rate of exchange current when the statement is made.

(C) The question says connections, not branches. It would seem as if this meant that the house merely bought and sold goods in a foreign country. The only items which would require special attention would be the debts due to or from the foreign connections.

As these would be current items they would be valued at the rate of exchange prevailing at the time the statement was made. This would not apply to consignments which would be valued at their cost plus expenses, and no attention would be paid to the rate of exchange until the goods were sold, when the net amount received would be credited at the same price. It is not at all probable that there would be any question of fixed assets at all.

(D) The principal point to be covered is the proper valuation of the property as a whole and of the individual lots. It is generally considered that all the expense which has been incurred up to the time when the first lots are ready to be sold should be added to the original cost of the land. Montgomery, however, enunciates the proper principle when he eliminates any selling expense. He says:

"Unlike a railroad the entire cost and expenses up to the time the property is ready to be marketed cannot be charged against the property. Only such part of the expense as really adds to the value of the property, such as the grading and paving of streets, the cost of the water and sewer installations, etc., is a proper addition to the capital account. Administrative expenses and any preliminary selling expenses, such as advance advertising, publicity work, printing and the preparation of maps, must be segregated and shown on the balance-sheet as deferred charges to future operations until such time as revenue begins to come in."

The only exception to be taken to this statement is the exclusion from the cost of any portion of the administrative expense. Supervision is necessary to the proper carrying out of the improvements which add value to the property.

The land cannot improve itself, the administrative expense of supervising the improvement should be considered part of the cost of the improvement itself.

Having thus obtained the cost of the whole tract, it is necessary to divide it properly among the lots. It will not do to divide the total cost by the number of lots, because some lots are worth very much more than others of the same size. All such enterprises have maps made of the property showing the selling price of each lot. This establishes the ratio between the selling price of each lot and the total selling price. This ratio is the proper one to use to determine the cost of each lot by its relation to the total cost. Thus, if the selling price of any particular lot is 1 per cent of the total selling price, the cost of that lot should be considered to be 1 per cent of the total cost.

The auditor should use the values thus obtained on the inventory of unsold lots and of the equities of those sold under contract.

There may be a difference of opinion as to how much profit the concern may be allowed to take on the lots already sold. The two extreme opinions are that all the cost of a lot should be collected before anything is credited as profit, and that the difference between cost and selling price is all profit, provided a reserve is set up to cover cost of collection. The best plan is to spread the profit over the entire time—that is, to consider that proportion of total profit on a lot as earned which the amount paid on the lot bears to its total selling price.

One other point that the auditor would have to cover would be occasioned by the existence of a mortgage on the entire tract. In such a case there would undoubtedly be a provision requiring the setting aside of a certain proportion of all cash received from sales to be applied on payment of the mortgage until it was entirely paid. The auditor should see that this provision had been observed.

Question No. 12:

In auditing the books of a corporation you find record of the ownership of stocks and bonds, some of which are in hand, some are deposited with bankers or others for safe keeping, and others are lodged as security for loans. State what kind of evidence you would require in each case, specifying particularly in the case of stocks and registered bonds, if not registered in the name of the corporation, what you consider necessary to protect your client's interests.

Answer to Question No. 12:

For those in hand I should require ocular inspection. I should also visit the banks holding the securities merely for safe keeping, and request that I be allowed to inspect them. As for those which are held as security for loans, I should be satisfied with a statement signed by an officer of the bank that the securities were in the bank's possession as collateral for loans, describing the loans.

The treatment of the securities not registered in the name of the corporation would depend upon the purpose for which they were held. If only for temporary speculation it would be sufficient if the stocks were registered in the name of a well-known broker and endorsed by him to make them negotiable. This is the customary method on the stock exchange. If the securities were held as a permanent investment I should require that they be transferred so as to be under the sole control of my client.

George Shillinglaw

We announce with regret the death of George Shillinglaw, of Cedar Rapids, Iowa, which occurred June 13, 1920. Mr. Shillinglaw was a member of the American Institute of Accountants, was prominent in the accounting profession in Iowa, and was a certified public accountant of that state.

The Journal of Accountancy

Official Organ of the American Institute of Accountants

Vol. 30 AUGUST, 1920 No. 2

Accounts of Engineers and Contractors*

By C. A. H. Narlian

In view of the dissimilarity between the balance-sheet items of a contractor and those of a manufacturing concern, the credit-men of banks are liable to find some difficulty in properly reading the actual financial status from the balance-sheet of the former, unless it is presented with considerable clarity. The banker is unable to apply some of the tests that he is in the habit of using, e. g., the ratio of merchandise on hand to sales, and that of accounts receivable to turnover. Moreover, the ratio of quick assets to current liabilities will not always show 1.5 to 1, which is usually the banker's minimum requirement. It becomes necessary, therefore, to supply the banker with a statement, supported by a profit and loss account, that will furnish him with the salient factors of the business, from which an analysis can readily be made. For this to be possible there is the fundamental requirement of a properly expressed set of accounts and a practical system.

A coördinated cost system will also be found of inestimable value in comparing, at frequent intervals, the actual unit costs with the estimates prepared by the engineer, upon whom devolves the work of classifying the various expenditures estimated, as to labor, material and overhead. Naturally, if the comparisons are to be of any value, the classification of accounts in the cost records should conform to that of the engineer.

At the outset I might say that I have found it not unusual for contractors to have little respect for the value of sound bookkeeping methods and to be content with charging to a single account, termed "contract," all labor and material items, applicable thereto, only when paid. Thus, the materials in some instances

* A thesis presented at the May, 1920, examinations of the American Institute of Accountants.

may have been used or consumed on the job, but no entry therefor will have been made upon the records. It will be obvious that by this method the accounts payable for purchases are not made a part of the records; whereas the setting forth of all liabilities is a most important factor without which nothing like a true statement can be prepared.

Recording of Materials and Supplies

It is assumed that all purchases are made by the general office, with the exception of minor requirements frequently of an emergency nature which are, for convenience, bought and paid for by the field office upon authority of the superintendent. These latter transactions can easily be handled by means of a revolving fund placed with the field office, invoices therefor accompanying the periodical report to the general office. Freight bills also would be paid from the revolving fund and be forwarded to the general office.

It will be found preferable to maintain stock ledgers, appropriately classified, in the field office which will be controlled upon the general ledger. To the various stock accounts, therefore, would be charged the purchases of all materials and supplies not going directly to the job. In the latter case it is more convenient and equally good practice to make the charge direct to the cost of contract.

Triplicate purchase invoices should be demanded from the vendor, the original being for use of the general office, the duplicate for the field office and the triplicate for the purchasing agent. After numbering each set of invoices received, they should be registered numerically and distributed, the original being filed pending the approvals for receipt of goods, and as to quantity, quality and price. The system that appears to the writer to have the greater advantages is the one which compels the receiving clerk to fill out a material receipt upon the delivery of goods without reference to the invoice. Under this method the material receipt is made up in duplicate, the original being perforated and sent to the field office stock ledger clerk who compares the quantities with his copy of the vendor's invoice and, if in order, mails the material receipt to the general office. Errors can frequently be corrected by this plan, without an unnecessary amount of correspondence.

The material receipt is then attached to the original invoice, which previously should have been approved as to prices and extensions, is ready for vouching, and when entered upon the voucher register will be charged to materials and supplies account.

Materials should be requisitioned from stores upon appropriate forms; and these should be summarized weekly or monthly by the field office, the summary being sent to the general office to be posted to the cost ledger, in detail, credit being passed to materials and supplies account. As an illustration of some of the various accounts that it may be found desirable to keep in the cost ledger, under the materials section, the following brief list is submitted:

Steel	Fuel
Cement	Gasoline for tractors, etc.
Sand and gravel	Repair parts for machinery
Lumber	" " " tractors, etc.
Hardware	Small tools

It would be well to mention that, inasmuch as many classes of materials are purchased under contract in specific quantities, it becomes desirable for the purchasing agent to keep a record of each contract, showing the quantities purchased and the unit price thereof, and also the quantities delivered thereunder in accordance with invoices, the balance undelivered being useful in indicating the occasional necessity of placing further contracts. It will readily be seen that on an ascending market these records will prove of value in assuring the company of total contract deliveries at the contract price.

Labor

Few difficulties will present themselves in the recording of the charges for labor. Perhaps the best method to be pursued is to have the payroll made up in duplicate and paid by the field office, for which a payroll fund would be maintained for the purpose of paying off men who leave between pay days. The payroll would be summarized as to distribution, according to the cost ledger classification, and the original would be forwarded to the general office for reimbursement.

Overhead

It is not intended by the writer that the salaries of the superintendent and clerks at the field office should be included under the caption "overhead," but that those charges should appear, as such, in the cost ledger, inasmuch as they are specifically allocated to a particular contract.

The accounts coming under this head would comprise the proportion of the general and administration expenses, as determined. The apportionment of expenses over the various contracts must be on an equitable basis, and there can be no objection to the use of total material and labor expenditures.

In regard to the question as to whether interest should be included under the heading of overhead, I can only say that it would seem preferable to me to exclude it and to treat it as a division of profits. This question is, of course, a moot point upon which there are, naturally, divergent opinions among accountants. If, however, interest on borrowed money is treated separately in the profit and loss account, it would appear to be the best practice to treat discounts taken on purchases as a financial item, by charging the work-in-progress account with gross invoice price, and discount would then be deducted from interest account in presenting the profit and loss statement. Depreciation on machinery and equipment, which naturally constitutes an important element of cost, will be discussed later.

Contracts are frequently entered into on the basis of unit prices for the various classes of work to be done, payment to be made monthly at the rate of 90 per cent of work completed, as computed and certified by the engineers. In this case the cost account is credited with 100 per cent, or in other words the total of the certified estimate; an account receivable is charged with 90 per cent thereof, the remaining 10 per cent being carried to an account termed "retention of percentage on work completed."

A bond for assuring completion of the contract is usually granted by the contractor, the premium of which can be either carried as a deferred charge and prorated or be charged to cost of work in progress direct, preferably the latter. Compensation insurance should be accrued at the policy rate applied to the monthly payroll, and any premium deposited should be carried as a deferred charge.

Machinery and Equipment

When a contractor has several pieces of work in hand at the same time, it becomes desirable to maintain a record of the individual items of machinery and equipment. A simple but efficient way in which this may be kept is to open an ordinary subsidiary ledger account for each machine, truck, etc., or by groups, as purchased, showing date purchased, name of vendor, unit price and amount, the controlling account thereof being kept in the general ledger. The particular contract upon which it or they are being used should be designated on the subsidiary ledger account. When the machine is transferred to another contract, depreciation should be calculated thereon for the time it has been in use and be credited to the account, cost of work being correspondingly charged under the head of depreciation.

The same procedure applies when a job has been completed, for all machinery and equipment used thereon. The balance of each account should then be brought down and notation should be made as to where the machine has been placed. It may be noted that it is preferable to apply the depreciation rate upon the original cost rather than the reducing balance. It would also be well to bear in mind that when a machine is placed in warehouse, depreciation should also be computed thereon, but at distinctly lower rates than when in use on contracts, and that this depreciation is chargeable to general overhead, as such.

At the close of a fiscal year it is inadvisable to depreciate machinery and equipment that is in use, if no profit or loss is being taken on the contract. It is preferable to account for depreciation only when a closing or part closing is made, at which time cost of work is charged, as described heretofore. In the opinion of the writer this method is sound, because depreciation on machinery, etc., taken while work is in progress, would have the effect of reducing fixed assets thereby and increasing current assets, inasmuch as a corresponding charge would be made to cost of work in progress, which is classified as a quick asset.

On the other hand, if a profit or loss is being estimated and taken on a partly completed contract at the close of a fiscal period, it becomes imperative, if good accounting is to be followed, to compute and set up depreciation of machinery and equipment for

the period in use and to charge it to cost before calculating the estimated profit.

It is hardly necessary to mention that depreciation on furniture and fixtures is chargeable as a general overhead expense and has no relation to direct cost of completed contracts.

Profits on Contracts

Perhaps one of the most perplexing problems that confronts the auditor who is called to examine the accounts of a contractor having large undertakings on hand at the close of the fiscal year, in various stages of progress or development, is to ascertain, with any degree of accuracy, the profit that fairly may be taken thereon. Several factors must be given due consideration, such as the proportion of the work completed, the existing labor conditions and other circumstances, the status of the contracts entered into for materials and in some cases the past experience of the contractor. In the final analysis, the estimating of part profits partakes more of an engineering problem than of one of accounting. It naturally behooves an auditor, however, to pay close attention to this important question.

In many cases it will be found not a difficult matter to ascertain with substantial accuracy the profits earned on contracts that have been only partly completed, provided the cost system is founded on good accounting principles and is expressive of the actual conditions, with a sufficiency of detail.

Illustration of such a case is found in the contract undertaken at unit prices for the several classifications of work performed and not at any flat figure. If the cost records reflect the actual expenditures under a distribution similar to that upon which the contract has been calculated, inasmuch as the reports from the field and the estimates approved by the engineers will show the amount of the work done under the respective classes to the closing date, the unit costs can be determined by dividing the units of work completed into the total costs thereof. The difference between the sum of the costs and the total of the amounts due under the contract, which is determined by multiplying the units of work completed by the respective contract prices, will represent the gross profit on the work performed, from which is deductible the proportion of overhead expenses.

Inasmuch as it is by no means a universal practice among

contractors to maintain stores accounts—the method employed being to charge all materials and supplies direct to the contract—it must be borne in mind that in such cases a physical inventory of materials unused and on hand should be taken as of the close of the fiscal year and be credited to the cost of work in progress, being shown separately in the balance-sheet under materials and supplies.

In the case of a contract which is practically completed, an estimate is made by the engineer of the cost of work to be done and by adding this amount to the cost to date, and deducting the sum from the contract price, the estimated profit is ascertained.

It would be well at this point to warn against taking profits that may have accrued on uncompleted contracts unless the work done has been of sufficient volume to warrant this practice; and it is the duty of the auditor to see that due allowance is provided for all contingencies and that the estimated profits are calculated upon a conservative basis.

On the other hand, it is incumbent upon the auditor to satisfy himself that there is no loss on an uncompleted contract, and if, upon investigation, a loss is disclosed he should not fail to give effect to the necessary adjustment to the accounts. It may happen, however, that the loss on one uncompleted contract is much more than offset by the part profits on other contracts, and that no cognizance has been taken thereof by the contractor. In this event it is usually considered sufficient to mention the facts in the report without adjusting the accounts.

When part profits are taken, it is by all means the best practice clearly to identify them as such in the profit and loss account.

Among the benefits from a good cost system is the valuable statistical information that is gained, providing, of course, that the system is efficiently carried out. The data furnished are most useful in comparing unit costs between different concurrent contracts and furthermore they form an essential basis for bidding on future contracts. This feature alone cannot be too strongly emphasized, since upon it may rest the success or failure of a venture of considerable magnitude.

Taxation of Capital Profits and Stock Dividends*

By Theodore Krohn

Extreme measures have been resorted to by congress during the last decade or so to defray the enormous expenditures of the government, recently increased in consequence of our entrance into the world war. The taxation laws in effect prior to the sixteenth amendment to the constitution of the United States, adopted February 25, 1913, had yielded, between those based on the benefit and ability-to-pay theories, sufficient revenue for normal requirements. The heavy drain upon funds in the treasury, however, presented a problem that could be effectively solved only by a more liberal application of the ability-to-pay theory of taxation, commonly known as the tax on income. The constitution had placed a limitation upon such a direct tax by requiring its apportionment among the states according to population. This obstacle to the income tax was removed after the requisite number of states had signified their approval of the sixteenth amendment, which provides that "the congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states and without regard to any census or enumeration."

Income taxation had reached a very progressive stage of development throughout Europe and Asia in a short period before its introduction in the United States. The basis of the law in this country is, with few exceptions, fundamentally the same as those of such taxes under other governments. It will suffice, therefore, to confine the consideration of the subject to problems suggested by the United States law.

Because of the complexities of modern business organizations, the task of framing the law was accomplished only after long and arduous labor; yet it is not surprising that developments in its administration have resulted in litigation in the courts. From the decisions and interpretations handed down there have

* A thesis presented at the May, 1920, examinations of the American Institute of Accountants.

been evolved many fundamental principles of income taxation relevant to the subject under review.

Capital Profits and Taxable Income

Capital and Income

In the case *Lynch vs. Turrish,* capital is defined as, "...... anything, material or otherwise, capable of ownership, viewed in its static condition at a moment of time, or the right of ownership therein........ In the actual production and distribution of capital there is a constant conversion of capital into income, and vice-versa."

Income has been defined as "a gain derived from capital, from labor or from both combined." The sixteenth amendment enlarges upon this definition in taxing "incomes from whatever source derived." An opinion of more direct application holds that "the increased value of capital as such constitutes in one sense a gain or profit but not income. Hence, such gain or profit is not taxable, but only such profits and gains as constitute income are taxable." In the decision handed down March 8, 1920, by the supreme court in the case *Macomber vs. Eisner,* which will be discussed later, income is defined as "......not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital, however invested or employed, and coming in, being 'derived,' that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal—that is income derived from property."

Income from Capital Assets

There is a marked distinction between income from trading in current assets, such as merchandise, or from wages, interest or rent and the profit or gain arising from the appreciation, exchange or sale of the fixed assets represented by land, buildings and security investments. The income of the former kind is taxable upon either the cash or accrual basis. It is evident that the income of the latter kind is of an unusual character—contingent and extraordinary, as distinguished, in an economic sense, from the normal returns on capital or goods used in the production of further wealth. Therein is found one fundamental difference between

the British law, which exempts such income from tax, and the law in this country, which recognizes no distinctions.

By what standard of valuation may these unusual profits from capital be measured? The income-tax law of September 8, 1916, states that the net worth of any business at March 1, 1913, represented capital, whether it embraced original capital contributed or accumulated profits. Thus only profits earned from the incidence of the tax may be subject to levy. In determining such taxable income the fair market value of assets at March 1, 1913, if acquired prior to that date, or the purchase cost, if acquired subsequently, is prescribed under the law of February 25, 1913, as the basis for determining a profit or loss upon exchange or sale. This arbitrary basis is not sound in principle. An actual loss may have been suffered, comparing the purchase cost of the asset with the selling price, but, due to intermediate fluctuations, the use of the arbitrary rate may require a tax to be paid as though, in fact, a profit had been received. The converse is equally true.

Appreciation in value of a capital asset is not taxable income. The decision of the supreme court in the case *Macomber vs. Eisner* explicitly sets forth the reason as applied to stock dividends, which is also true of other capital assets. It emphasizes the fact that to be income such appreciation must be realized upon a closed transaction and be ". . . . something of exchangeable value, proceeding from the property, severed from the capital however invested or employed, and coming in, being 'derived,' that is, received or drawn by the recipient. . . . . ." An actual sale is practically the only answer to this description. Among economists and authorities on taxation there is a strong belief that appreciation of capital assets, held as investments and not as stock-in-trade, should not be taxable as income even if derived upon sale. Early decisions in the courts support this contention. In the case *Gray vs. Darlington,* relating to the income-tax law of 1867, the court held that ". . . . . .the mere fact that property has advanced in value between the date of its acquisition and the sale does not authorize the imposition of the tax on the amount of the advance. . . . . . It constitutes and can be treated merely as an increase of capital." According to the present law the full appreciation in value of the property from March 1, 1913, or date of purchase to the date of sale is income taxable in the year during which the sale was

consummated. In view of the progressive rates of the surtax and excess profits taxes it is contended that the taxable profit thus realized should be pro-rated over the taxable years between purchase and sale, and the taxpayer be permitted to amend his previous returns accordingly. Even if it were practicable, such treatment has been negatively decided by the supreme court, holding that the gain is taxable income in the particular year of its receipt. So as to defeat attempts at evasion, the internal revenue department has ruled that in the sale of capital assets of the same kind, the first purchases are also assumed to have been sold first, unless evidence is produceable to the contrary.

Exchange. When property is exchanged for something capable of being readily converted into cash, it is, in effect, a sale. But the case is different when the value of the capital asset received in exchange is difficult to ascertain. The revenue act of 1918 provides that "when property is exchanged for other property, the property received in exchange shall, for the purpose of determining a gain or loss, be treated as the equivalent of cash to the amount of its fair market value, if any." In view of the decision in the case *Macomber vs. Eisner,* it is very unlikely that this provision will be upheld. If the property received in exchange was actually sold for cash upon its receipt there would be no argument. But the market value upon sale at a subsequent date will most likely be different from that prevailing at the date of the exchange. It is evident that no taxable income is derived until the final sale is made, the profit then being the difference between the cost of the old property and the sales price of the new property.

This is substantially the ruling of the treasury department in making an exception where "in connection with the reorganization, merger or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value." In this instance the old securities are replaced by the new. In ascertaining the profit or loss upon sale of the new securities, the original cost to the taxpayer or the fair market value as of March 1, 1913, of the old securities, less any untaxed distribution made by the new company from the capital or surplus of the old company, is the basis to be used.

Income from Investments in Capital Stock

Consideration of the subject to this point has been confined to the asset side of the taxpayer's balance-sheet. Thus far, income was divided into two classes: that is, from trading in current assets and from capital assets. There is a very important subdivision of the latter class—the income from investments in stock of corporations—which can be best discussed now in conjunction with the treatment of corporate surplus after its distribution, as affecting its taxable status to the stockholder.

A corporation is an entity distinct from its stockholders. Both are taxed upon its net income: the corporation at an even low rate for the normal tax to insure a return from all of its taxable income as well as by the progressive rates of the excess profits or war income taxes; the stockholders upon dividends at graduated and progressive rates for the rest of the tax, providing their income from other sources, together with income from dividends, renders them liable to the surtax. Dividends distributed from surplus are not taxable when arising from the appreciation of assets, from the sale of treasury stock or from the purchase of the company's stock below par. The excess of liquidating dividends over the fair market value of the stock at March 1, 1913, or cost if acquired subsequently, is taxable, provided that if any part of the distribution is from surplus accumulated prior to March 1, 1913, it is exempt from the tax. The stockholder is also taxed upon the sale of his stock for the amount of sales price in excess of cost or fair value if acquired prior to March 1, 1913.

In the case of an individual, partnership or personal service corporation, profits are taxable within the year earned; whereas in the corporation form of business organization, the income of the stockholder is not subject to taxation until distributed in the form of a dividend. This is even further qualified by the decision of the supreme court on stock dividends in the case *Macomber vs Eisner,* which will be discussed later. Dividends are not necessarily distributed in the year earned. The policy of the corporation in such matters is determined by the board of directors. It would seem only fair that corporations ought not to be privileged to choose in what year their earnings become taxable to stockholders when no such advantage is offered to other types of business organizations.

In this is found one of the most perplexing problems confronting the authorities in the administration of the law. Corporations might easily accumulate their earnings for any number of years, providing the stockholders were in accord with the policy. Such action would not be evidence of fraudulent attempt to evade the tax. Upon obtaining evidence of such intent, of course, the internal revenue department could take adequate measures to defeat it. In the law of October 3, 1917, section 10, provision was made for levying an additional tax on any undistributed surplus unless invested in assets reasonably required in the business or in the obligations of the United States issued after September 1, 1917. In but few known cases was this measure employed. In subsequent laws this section was omitted. Under the present law, where the intent to evade is evident and the commissioner of internal revenue certifies that in his opinion such is the fact, the corporation is required to pay only the war-profits and excess profits taxes and the balance of net income is taxable to stockholders according to the method prescribed for members of a partnership or personal service corporation.

It is fully recognized that legitimate reasons exist for accumulating corporate surplus. These were advanced by the American Institute of Accountants in the protest to congress against the adoption of the section of the law of October 3, 1917, taxing undistributed surplus. The outstanding points applicable to this instance, summarized briefly. are:

1. Rising prices increase the demand for working capital. Profits are absorbed in merchandise, accounts receivable and other current assets.
2. Industrial expansion resulting from war and post-war conditions creates the need for additional plant and equipment. The profits are also invested for such purposes.
3. The contingencies of additional tax assessments where returns are prepared and rendered, based on the best information and advice obtainable, and for other liabilities, are met by appropriations from earnings.
4. Corporations financially embarrassed prior to the present period expect to strengthen their position by accumulating earnings.

For each of the above reasons it appears that corporations so affected are justified in accumulating surplus. Notwithstanding, a surplus of any great magnitude is the constant point of attack of taxation authorities. There is always a possibility that the commissioner of internal revenue will declare that the amount of surplus is unreasonable for the demands of the business and levy a tax upon stockholders for their distributive shares. Occasions naturally arise when stockholders require a return of income from their investments and would rather receive it in the form of dividend than be forced to liquidate their securities. A corporation may find it necessary before reorganization, merger or consolidation to adjust its capital stock and surplus by a dividend payment. It is evident that in the cases enumerated above, where the surplus is invested in assets of the business not readily convertible into cash, a cash dividend cannot be distributed. A stock dividend, though, can be distributed to old stockholders in proportion to their holdings by conversion of the surplus into an additional issue of capital stock.

Taxation of Stock Dividends

The question whether a stock dividend made lawfully and in good faith against profits accumulated by a corporation since March 1, 1913, is income to the stockholder subject to taxation under the sixteenth amendment to the constitution of the United States or is merely a change in the form of evidence of ownership in the assets of the corporation has been argued in the courts for over a half-century. The recent decision of the supreme court handed down March 8, 1920, in the case *Macomber vs. Eisner,* held that such stock dividend was not taxable income to the stockholder. Unusual importance attached to the decision, not alone because it settled the particular point of the taxation of stock dividends but because in so doing it defined in clearer terms than heretofore the principles of capital vs. income, appreciation of capital assets vs. income derived from capital and the relation of stockholder to corporation.

The limitations of this paper will permit only brief comment on the important points established by the decision. A stock dividend is neither capital nor income. It results in no increase in the stockholder's investment nor in his buying power as evi-

denced in cash or its equivalent. The net worth of the corporation is precisely the same after the distribution as it was before. Taxing a stock dividend would not differ from a levy upon the old stock, being in either case, then, a capital tax not within the scope of the income-tax law. The fact that stockholders have a contingent interest in the undistributed surplus enhances the value of their holdings, but such interest is not increased by the receipt of a stock dividend, except in so far as such evidence of prosperity of the corporation affects the market prices of the stock. Practically the same rights in the surplus may be acquired through the purchase of the corporation's stock. The cost to the new stockholder includes a premium in payment for the contingent interest in the surplus surrendered by the old stockholder. The government receives the tax on such premium in full if the stockholder selling the stock is one who acquired it at par. Any further depreciation or appreciation is considered upon the successive sales or upon liquidation of the corporation.

A tax on stock dividends upon receipt and again upon the profit realized upon the sale is double taxation. An instance of this is found where stock is purchased above par and thereafter a stock dividend is issued. The tax collected on the premium realized upon the sale would again be exacted from the purchaser on the basis of the stock dividend he received.

The sale of dividend stock is not income to the full amount received. The cost of each share of such stock, represented by the cost of the old stock divided by the number of old and new shares added together, must first be deducted before ascertaining the taxable income. Similarly, the cost of each share of the old stock is the quotient of the cost of the old stock divided by the number of old and new shares.

The government's need for the tax now is more pressing than it is likely to be years hence. The effect of the decision is to reduce the tax collectible from recipients of stock dividends and to postpone the date of final accounting for the surplus of the corporation until actual sales of the dividend stock are made or until the corporation is liquidated. An effective tax is one which collects a particular year's budget with ease and certainty from the income indicated in the original estimate and within a short

period of time. It is obvious that in this respect the law is dangerously weak.

The conclusion reached by many, that by delaying accounting for the tax to subsequent years a saving is effected, cannot be accepted without qualification. A sound financial policy has for its object the spreading of taxes over a period of years as against a heavy levy upon accumulated earnings in one year. Especially is this true if in the years covered in the accounting, graduated and progressive rates of taxes are effective.

The distribution of dividends in stock, where paid in cash before, gives rise to discrimination in favor of the stockholders in that they may control the profits from their dividend stock sales so as to offset possible losses of lean years and thus effect a tax saving. The recipients of income from sources other than from investments in stock do not enjoy such privilege except in unusual cases due to war conditions. If at all, discrimination should be directed against "lazy capital," represented to a large extent by investments in securities.

The conservative policy practised by corporations in accumulating surplus as a margin of safety against contingencies is encouraged as a result of the decision on the taxation of stock dividends, as demonstrated by the numerous and large stock dividends distributed since the decision became public. The directors of corporations, in adopting such a policy, no doubt have in view considerations of vital importance that will be apparent only after the impending period of deflation and liquidation shall have shown its effects.

The treasury department has a responsibility to the taxpayer which in the interests of public welfare should be speedily discharged. The huge sums involved in pending claims for rebates for taxation and, on the other hand, contingent additional assessments on the part of the government against taxpayers should be definitely and finally settled. The decision of the supreme court in the stock dividend controversy will be a considerable relief to the tax authorities, the corporation and its stockholders. It should be followed by treasury decisions in regard to other capital profits affected, which have been referred to in the course of this paper.

Accounting for Retail Shoe Stores*

By T. J. Ahlberg

Generally speaking, retail shoe store accounting is comparatively simple and no very difficult problems are encountered. However, as in any other business, certain phases of operating must be carefully watched by the management.

In this day of high prices and low production it is essential that the purchaser be careful in selecting merchandise of standard grades and styles, in order to be sure of its ultimate sale and to prevent any accumulation of freak styles which may not be easily moved. So it behooves the retailer to watch his stock closely and inaugurate reduction sales on all "slow" merchandise. The public has gradually become accustomed to paying high prices, but on the other hand it demands value for the money expended. The purchasing department must, therefore, buy carefully and of conservative styles.

The stock-keeping records should be complete in every detail and should reflect the essential elements of grade and style as well as quantity, mark-up, etc. It is an important factor in retailing to carry a perpetual inventory, classified first as to kind (men's, women's, boys', etc.), then as to grade (price in this case), next, line (low, high or freak). Subclassified under these divisions would come the size, stock number and any other elements which may affect the turnover. Such a record would enable the management to dispose of the slow moving merchandise and would assist in determining the trend of the public demand. In this latter particular it would assist in future buying, which in turn would materially increase the percentages of turnover and therefore increase profits.

The objection generally brought up in regard to this detail is that it carries with it an expensive clerical force to handle the entries, but in some cases with which I am familiar it has produced actual results in turnover and has been acknowledged an aid in the purchasing end of the business as well as the sales. Much, of

* A thesis presented at the May, 1920, examinations of the American Institute of Accountants.

course, depends on the personnel in the management of a business and the human element enters largely.

All expenses of the business as well as the merchandise received should be accrued or entered on the purchase record or voucher register. Such a purchase record appears on page 100.

This record can be enlarged to meet the requirements of the business. The detail of the merchandise received can be entered on the stock sheets from the information shown on the invoices when entered in the purchase record.

Sales

With each sale ticket there should go to the office a record of the cost and sales price (cost preferably in code) from which a record is made on the stock sheets as to cost and on the sales sheets as to cost and sale. It is a prime necessity to follow the fluctuations in sales and for that purpose a columnar sales record should be kept. The daily sales are summarized first under the kind and then in columns as to cost and sales price. This will enable inventory control accounts to be kept in the general ledger, which will be debited with the purchases and credited with the cost of sales each half month or month, whichever is the more advisable. The other entries from the sales record would be a debit to cost of sales account and a credit to sales account. A sales record of this character appears on page 100, but other columns can be added if desired.

Under findings should be grouped repair work, laces, etc. All further detail as to the moving of any particular styles can be determined from the stock sheets hereinbefore outlined. Return sales are not so numerous as to entail a great deal of clerical work. All returns should be entered on a return sales summary as to cost and selling prices and the postings to the general ledger accounts would necessarily be the reverse of the sales exhibits. In this method no sales postings would be made from the cash receipts book for sales or from the cheque register for return sales, but all postings would be made from the summary sheets. The detail of return sales would be entered on the stock sheets in the same way as purchases and at the original cost price.

The operating accounts which an average business should carry on the general ledger follow, showing the explanation necessary.

Sales—(departmentalized to conform to requirements as shown in the sales summary)

Credited with:

Cash and charge sales of merchandise from the sales summary.

Debited with:

Return sales and allowances from the return sales summary.

Cost of Sales—(departmentalized as above)

Debited with:

Cost price of sales from the sales summary.

Credited with:

Cost price of return sales from the return sales summary.

This account would necessarily include cost of freight, express and cartage on the merchandise sold, mention of which is made later under the inventory accounts.

Buying Salaries

Debited with the salaries (or proportion) of all buyers and clerical assistants directly assigned to that work.

Buying Expense

Debited with all expenses incurred by the buying force such as traveling and all other expenses applicable thereto.

Sales Salaries

Debited with the salaries of the sales force both regular and extra, including floormen, salesmen, stock boys, wrappers and a proportion of the cashiers' time.

P. M's.

Debited with commissions, bonuses, etc. commonly known as P. M.'s.

Advertising

Debited with all expense incurred for newspaper space, circulars, street car cards, billboards, window display, light applicable, and button hooks, shoe horns or other "novelties"; also any donations which are distinctly a necessary part of publicity and from which a benefit is derived.

Other selling expense

Debited with sundry miscellaneous expenses, such as wrap-

PURCHASE RECORD MONTH OF ....19....

Date	Supplier	Accts. payable	Men's		Women's		Chil-dren's	Find-ings	Expenses				
			High	Low	High	Low							

SALES SUMMARY MONTH OF.......................19......

Date	Men's High		Men's Low		Women's High		Women's Low		Children's		Findings					
	Cost	Sale	Cost	Sale	Cost	Sale	Cost	Sale	Cost	Sale	Cost	Sale	Cost	Sale	Cost	Sale

ping paper, twine and other selling expense not included in the foregoing accounts.

Delivery Expense

Debited with wages of drivers and wagon boys, automobile expense, horse expense (feed, shoeing and stable), repairs, taxes and insurance on delivery equipment.

Delivery Equipment Depreciation

Debited with depreciation on automobiles, trucks, wagons, horses and other delivery equipment.

Office Salaries

Debited with salaries of office force not directly chargeable to buying or selling salaries.

Office Expense

Debited with sundry expenses of maintaining the office.

Stationery, Printing and Postage

Debited with stationery, postage stamps, stamped envelopes, accounting forms, etc. Does not include postage for advertising purposes.

Insurance

Debited with the expired portion of insurance premiums of all classes except delivery equipment.

Taxes

Debited with taxes on merchandise stock and all other taxes with the exception of federal income and excess profits taxes.

Rent

Debited with rent of store and any rented equipment used and for storage space.

Heat, Light and Power

Debited with purchases of fuel, light, power and supplies appertaining thereto; also wages of engineers, firemen, etc.

Repairs

Debited with incidental repairs to furniture, fixtures or store equipment.

General Expense

Debited with janitors' wages, telephone, telegraph, cleaning, dues and subscriptions and other sundry items.

Donations

Debited with contributions from which the business derives no direct benefit, which are not deductible in deter-

mining federal taxes (if corporation, not deductible; if individual or partnership, to a limited extent).

Bad Debts

Debited with losses on customers' account appertaining to current year's sales.

Credited with recoveries on above item.

Losses sustained on sales to customers in previous years are a charge to surplus.

Discount Earned

Credited with discounts taken on merchandise purchases.

Debited with discounts taken but subsequently not allowed by creditor.

Income Tax

Debited with amount of tax accrued and payable. Reverse entry would be a credit to accounts payable or accrued income tax.

Discount Allowed

Debited with discounts allowed to customers (very infrequent).

Interest Earned

Credited with interest earned and received on notes receivable or customers' accounts.

Interest Expense

Debited with interest accrued or paid on borrowed money.

Cash Over and Short

Debited or credited, as the case may be, with all irregularities in daily cash transactions.

Miscellaneous Earnings

Credited with sales of waste paper, boxes, etc.

Depreciation

Debited with amount provided as depreciation for period.

Interest on investment in business is not considered in this outline of accounts.

The balance-sheet accounts would be as follows:

Bank, Cash

Debited with cash receipts from all sources which should be deposited daily.

Credited with disbursements by cheque.

Balance at end of period shows cash on deposit not withdrawn.

Imprest Fund

Debited with original amount drawn for the office cash. All subsequent reimbursements are distributed on the voucher register.

Notes Receivable

Debited with notes taken in payment for merchandise or on loans made to individuals.

Credited with payments made on principal or notes written off as bad debts.

Accounts Receivable

Debited with all charge sales to customers.

Credited with payments by customers, returned merchandise, sales, allowances, bad accounts written off and notes taken in payment of open account.

The balance of this account should agree with the sum total of the individual accounts in the customers' ledgers at any given posting period.

Inventory—(departmentalized as detailed in purchase record).

Debited with merchandise purchased and return sales at cost, plus freight, express and cartage.

Credited with cost of merchandise sold and credit memos. received from creditors (not including cash discount).

Fixed Assets Accounts (classified)

Debited with purchases of real estate, buildings, furniture, fixtures, equipment, delivery equipment, etc.

Credited with cost value of above items discarded or sold.

These accounts should show the cost value of all equipment used at any given date.

Insurance Unexpired

Debited with insurance premiums on merchandise, buildings and equipment.

Credited with expired portion of premiums.

Notes Payable

Credited with funds borrowed on notes.

Debited with payments of principal on notes.

Accounts Payable

Credited with recorded purchases.

Debited with payments to creditors, allowances to creditors, and returned purchases and notes given in settlement of open accounts.

Reserves for Depreciation—(classified as to fixed assets analysis).

Credited with amount provided during period.

Debited with proportion previously reserved, in case of discarding or sale of fixed assets.

Investment Accounts

In the case of a corporation, capital stock and surplus accounts. In the case of individual or partnership, the respective investment accounts.

In the accounts herein provided no provision is made for depreciation of stock. This is ignored for the reason that in order to follow out the detail of this system it is necessary to carry the control inventory at actual cost. In case of a desire to provide for losses on obsolete stock an entry can be made debiting depreciation on stock and crediting a reserve account, thereby not affecting the actual inventory cost records.

In determining the departmental profit and loss it is an easy matter to allocate the expenses incurred against the various departments. In this arrangement of accounts we already have an actual gross profit, so the problem confronting us is the distribution of the overhead to the departments.

Rent should be allocated in the proportion of space occupied by each kind of merchandise. The distribution of buying salaries and expenses can be determined from the time spent on purchasing each kind of merchandise, and the cost of sales method would no doubt provide a correct basis for distribution of departmental overhead.

P. M's. distribution can also be easily determined in accordance with the merchandise on which P. M's. were paid. Taxes and insurance should be distributed on the basis of the value of each kind of merchandise used in calculating taxable or insurable values.

In short, all expense that can be distributed departmentally on a known basis should present no great problem, albeit it may

necessitate some clerical labor, and the other expenses can be distributed on the cost-of-sales basis as perhaps the best method.

Thus actual profits in all departments can be determined and will afford the management a greater insight to operations than if handled loosely. It is essential to discontinue the unprofitable elements of a business and specialize on the more profitable items.

The most essential part of the foregoing plan of accounts is the stock sheets, which will enable the management to keep in close touch with the moving of styles and will prevent any undue accumulation. Strict adherence to the detail outlined will produce results and will fully warrant any added expenditure for clerical assistance.

Accounting for an Export House*

By Maxwell Shmerler

The methods employed in carrying on an export business differ radically from those of ordinary mercantile or manufacturing business. As a result the accounting system and procedure present many peculiar features worthy of special consideration.

All export business may be generally classified in the following groups:

1. Concerns carrying on a general export business, extending credit to their foreign customers.

2. Concerns limiting their operations by withholding credits and selling for cash against shipping documents only.

3. Export operations carried on as a department of a mercantile or manufacturing concern, in which case the business may be operated under either the first or second plan.

The present discussion will concern itself solely with consideration of the first of the above groups, because of its broader scope.

A brief outline of the business procedure with special emphasis on the points of peculiarity is presented for the better understanding of the subject.

The commodities handled by the general export house represent products of every conceivable nature. This necessitates the keeping of accurate records of sources of supply, properly catalogued by name of product and source.

The method of handling the order does not differ much from that employed in other businesses, except that the routine involved in dealing with export orders carries with it certain technicalities peculiar to itself.

As a result of solicitation or circularization, the foreign customer sends in his requirements for commodities and invites quotations. At this point the records of sources mentioned above become the most important factor in the promotion of business.

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*A thesis presented at the November, 1919, examinations of the American Institute of Accountants.

These records should readily show where such goods can be obtained at the cheapest possible price, in order to meet competition, which in the nature of the business is very keen.

As soon as the order is accepted, purchase orders are issued for the goods with shipping instructions to deliver at a designated point near the specified steamship.

The shipping department calls for the most technical knowledge and information. However, for present purposes it suffices to point out merely that, as a general rule where the shipping and traffic departments are combined, that department should be equipped with records and files whereby all orders and purchases for such orders can be classified as to time of delivery, destination, etc. In many instances it may also be necessary to arrange the orders under the name of the steamer by which they are to be shipped. This is necessary to center attention on orders to be shipped on one steamer so as to avoid leaving parts of orders behind.

When the goods are shipped and charged, a draft is drawn for the amount of the invoice and forwarded through the bank for the customer's acceptance or payment.

Generally time drafts run from 60 to 120 days or over. A common practice is to draw 30 or 60-day sight drafts. This means that the drafts are due 30 or 60 days after they are accepted. These drafts are presented for acceptance when the goods reach their destination. Thus, allowing from 30 to 60 days for delivery, the actual credit may extend for a period even longer than 120 days.

In the case of a business of considerable volume, it becomes necessary, therefore, to resort to special bank credits. The common practice in such circumstances is to borrow from banks, placing with them as collateral drafts receivable for collection. Collections made by banks are credited to a special account, from which the loans are deducted when due.

From the foregoing, it may be seen that the matters of greatest concern from the accounting point of view are the purchases and drafts receivable.

Purchases

Without minimizing the importance of stock records for any business, it may be stated safely that in no case is a properly

controlled stock system more urgently needed than in an export business. The chances for clerical errors involving losses are greater in an export business operating without a stock system than in a trading or manufacturing concern in similar circumstances. While, for example, in the latter case, charges to customers are made and checked with the actual physical merchandise, in the former case all charges must be made from creditors' invoices. Thus, should invoices be lost or mislaid, the shipment is liable to go forward with items uncharged.

While stock systems are always highly desirable, it must be recognized that there are conditions in certain cases which make a properly controlled stock system impossible. This, however, is not true of export trading. Here a stock system falls directly in line with a good accounting system, because it is based upon the following simple propositions:

1. All purchases are for specific orders. Goods of similar kinds are not merged and do not lose their identity.

2. All shipments to customers are made from such identified purchases.

3. The balance of purchases which have not been shipped and charged to the customers represents the stock inventory on hand at any given time.

The above facts are brought into the books in the following manner:

All purchase invoices are entered in a voucher register.

The total of the merchandise column in the voucher register is posted to the debit of the inventory account and the total of cost-of-goods-sold column of the sales journal is posted to the debit of cost of goods sold and to the credit of the inventory account. The balance of the inventory account represents the purchases unshipped. A detailed list of all items in support of such inventory is then made by listing in the voucher register all merchandise items that have no posting under the column "charged." Thus from the voucher register we obtain two lists—the unpaid vouchers and the uncharged purchases, both of them operating upon the same principle.

The form on page 109, while intended merely to illustrate the principles involved, will also be found to be practical in most instances. For example, in addition to the above it may also

Form 1

VOUCHER REGISTER Month of ____________ 19__

Voucher number	Date of bill	Name	Shipping Marks	Amount of bill			Paid		Distribution			Charged	
				Gross	Discount	Net	Date	Cheque No.	Expenses	Sundries	Mdse.	Date	Sales Book Folio

be desirable to keep a separate account with each shipment, showing in detail all costs and charges. This can easily be accomplished with the assistance of the system outlined above.

It is essential that the sales journal be so arranged as properly to classify the amount of the sale. The most important classifications necessary from the accounting point of view are the following:

Merchandise.
Shipping expenses—such as packing, consular fees, etc.
Commission charges.
Interest charges.

All vouchers for purchases for orders are entered in the merchandise column. When goods are shipped and charged, the date charged and sales book folio are entered on the line upon which appears the purchase, at the same time posting the amount of the purchase against the charge for it in the sales book. For that purpose, the sales book should be arranged as in form 2 (page 111).

The first of these only represents the income from sales. Shipping expenses are advanced for the customer and charged on the bill in the same form as paid. The interest and commission, however, represent separate income and should so appear on the books.

When for various reasons the classifications cannot be carried through the sales journal (in case, for example, the sales journal consists of copies of the invoices filed in a binder), a sales register properly arranged to give effect to the above plan should be used.

Drafts Receivable

A matter of equal, if not greater, importance is the proper method of accounting for the drafts receivable. In a general way, the handling of such drafts has been explained already. The drafts in their relation to the loans made against them may be further explained as follows:

Loans on drafts are made in one of three ways:

1. Drafts sold to banks under the usual form of discount.

2. Loans made against individual drafts up to a fixed percentage of the face value.

3. Loans made on an aggregate of drafts deposited with

Form 2

SALES BOOK

Month of________19__

Particulars	Price	Amount	Total	Cost of goods sold		
				Voucher No.	Amount	Total

the bank for collection, in which case the bank is not compelled to apply the collection of a certain draft against the specific loan made thereon.

In the case of drafts discounted, the accounting procedure is simple. The ledger accounts should clearly indicate and differentiate between the drafts in possession and those for which there is a contingent liability. The three accounts necessary to give effect to this method of procedure are drafts receivable, drafts receivable under discount and drafts receivable discounted.

The account drafts receivable should contain all the drafts unsold. The account drafts receivable under discount should represent all drafts discounted at banks, against which the offsetting account is drafts discounted, showing the extent of the contingent liability.

With regard to the first and second group, it may be said generally that the manner in which those drafts are treated corresponds closely to what is generally known in other business as discounting customers' accounts.

In many cases it is found that a combination of the second and third method of financing the draft is employed. The use of either one will depend entirely upon financial arrangements with the banks. It is not customary for one bank to handle such drafts under both methods.

Form 3 (page 113) illustrates the information generally necessary in regard to such drafts, as well as the proper means of giving effect to all the facts on the ledger.

This form is to be used both as a book of original entry and as a ledger.

It is desirable that the book be in loose-leaf form and that all drafts placed for collection with a certain bank be entered under the account of such bank. This is necessary for the purpose of gathering all information relative to drafts held and loans made by each bank.

The general information required from the drafts receivable register will seldom be more than that provided on form 3. It will be noted that, contrary to usual forms covering similar transactions, the tickler is eliminated. The reason is that in the majority of instances the exact due date is not known. As

Form 3

DRAFTS RECEIVABLE Month of__________19__

PLACED FOR COLLECTION WITH__________BANK

Draft number	Date	Name	Time	Folio	Amount of draft		Paid				Loans against drafts					
									Amount		Borrowed			Repaid		
					Dollars	Foreign	Date	Folio	Dollars	Foreign	Date	Folio	Amount	Date	Folio	Amount

previously explained, most drafts are issued at 30 or 60 days from sight. The experience of exporters is that in some places it is, the business custom to examine the goods before accepting the draft. Thus, the New York office learns the exact due date only when it is informed by the foreign correspondent of the date of acceptance. For this reason it is useless further to burden this book with rulings that in all likelihood will not be used.

This form consists of three sections. The first is that covered by the columns under "amount of draft." The individual items under this column are posted to the credit of the customer's account and the total of the column is posted at the end of the month in the general ledger to the debit of the account under the heading "notes receivable for collection at banks."

The second section of this book deals with the payment of drafts. The information, so far as the drafts receivable register is concerned, is simple. All the facts required are date of payment, folio from which amount is posted and amount of draft. The source from which this information is gathered is, however, very important. A proper form is submitted and explained later.

The third section of the book is designed to cover all cases in which loans are made against specific drafts. It is advisable that in such cases each draft should show clearly the entire history of the transaction, so that when a draft is paid the record will show that the bank has been paid for the loan. This will make it possible to prepare at any time a detailed list of all drafts held by the bank and the net equity in each of such drafts. When the financing of the drafts is done on the basis of group 3, as explained above, the last section of this form is useless.

Form 4 (page 115) shows clearly the method of gathering all the information and recording it for the purpose of the general ledger accounts.

The use of a special form for this purpose is necessitated by the special circumstances. According to usual custom, when notes are collected by the bank the customer receives credit on his regular account. In the cases under consideration, however, such collections, as explained before, are held in a special account for the purpose of meeting the various loans made against drafts, and only the surplus in such special accounts is transferred to the regular account.

Form 4

DRAFTS RECEIVABLE CLEARANCE JOURNAL

Drafts cleared for the month of ______________ 19 ____ By ______________________ Bank

Drafts collected									Deductions by bank for loans against drafts			
				Credit		Debit						
Date	Draft number	Name of account	Folio	Drafts Receivable	Interest	Exchange	Special bank account for net cash	Customers acct. for drafts ret'd. uncollected	Date	Folio	Amount Dr. Loan Account Cr. Specl. Bank Acct.	Remarks

This form is self-explanatory. It is based upon the following journal entries:

When the bank notifies the office that a certain draft is collected

Debit special bank account with net cash collected.

Debit exchange or other expenses incident thereto.

Credit drafts receivable for collection with bank.

Credit interest received.

If this transaction also involves the clearing of a specific loan against a draft, the entry is

Debit loans payable secured by drafts.

Credit special bank account.

The general ledger accounts for drafts and loans against drafts are as follows:

1. Drafts receivable at banks for collection.

This represents all the drafts receivable outstanding. The information for this account is posted as to the

Debit (a) from the drafts receivable register at the end of the month.

Debit (b) from the drafts receivable clearance journal representing any drafts returned unpaid.

Credit from the drafts receivable clearance journal, the total of the credit, drafts receivable column.

2. Special bank account.

This account is debited from the drafts receivable clearance journal with all collections of drafts and credited with any repayments of loans, so that the net balance of this account at any one point represents the actual cash held by the bank from collection of drafts against its loans.

3. Loans payable secured by notes.

This account should represent all loans made against drafts, the credit being by cash and the debit generally by an entry transferring the cash held in the special account against the loan.

Emphasis is laid upon the nature of these accounts and the

necessity of stating them as outlined above on the ledger, for the very good reason that correct accounting principles require that they be so stated. In the ordinary course of events, however, when transactions are numerous, it is also necessary to provide an export office with the proper subsidiary records—otherwise the auditor is at a great disadvantage in the preparation of his reports.

Accounts for the Manufacture of Wood Veneer*

By Harold C. Jordan

The product of woodworking industries is of wide variety and frequently the particular product manufactured requires specially planned accounts to meet the peculiarities of the business. The subject of veneer manufacturing is an instance illustrating special requirements.

The product of the industry consists either of single pieces of veneer a fractional part of an inch in thickness or pieces glued together in such a way that they form panels of two or three layers of veneer. The number of layers forming a panel is indicated by the terms two-ply, three-ply, etc. In manufacturing the two-ply panels, one of the two pieces of veneer used is called the face and the other the back. In the case of three-ply panels the pieces are called the face, the center and the back. Ordinarily the quality of wood used for the faces is better than for either the backs or centers. Many pieces of veneer break with the grain of the wood in the drying process and these broken pieces are sorted and fitted together so that they form centers when bound with adhesive paper tape.

The product is sold by the piece and the prices per piece range upward according to the square measure, thickness of stock, number of ply and variety of wood in each piece. In order to fix prices for competitive quotations it can be readily understood that some method for obtaining the cost of manufacturing pieces of veneer of varying measurements and quality is essential. A description of such a method and the manner of weaving it into the general accounting will form the principal part of this discussion of the subject matter.

The accounts in the general ledger should include those usual to a manufacturing system of accounts. Accounts should also be kept representing in-process, stock in stores, sales, cost of sales and overhead.

* A thesis presented at the May, 1920, examinations of the American Institute of Accountants.

Before taking up the details of collecting cost data it may be well to present a brief description of the material and operations entering into the manufacture of veneer.

Material used consists principally of logs. The logs are sometimes acquired by purchase in the market or they may be cut from the company's own timberland. The logs are yarded in the mill yard and brought into the mill as they are needed for work orders. Glue, sandpaper and tape are other materials used.

Not many operations are necessary in manufacturing veneer. The logs are brought into the mill, sawed into bolts, the bark removed and the bolts placed in a steam vat for steaming. After the process of steaming is completed the bolts are taken out of the vat and placed in a veneer machine which turns off long strips of veneer of whatever thickness is desired. The strips of veneer are then cut into square or oblong pieces by a cutting machine. Drying is the next process. When the pieces of veneer are taken from the dryer they are placed on trucks and either carried to the stock room or sent directly to the gluer for making into ply stock. Pressing, sanding, sizing, taping and crating are the only other important operations which need be mentioned.

For cost accounting purposes a work-order number should be given each lot of veneer or panels to be manufactured. The work-order sheet should be in duplicate, one copy for the superintendent and one for the office. If veneer stock is manufactured in anticipation of prospective demand, authorization numbers should be used and entered on work orders to designate an aggregation of product that, it has been determined, it is desirable to manufacture. The work orders with appropriate numbers and descriptions should be retained in the office and superintendent's files awaiting the time when the superintendent wishes to start work.

Time and material tickets should be used as a medium for collecting cost information in the mill. For the purpose of illustrating as clearly as possible the use of these tickets as they pass through the mill let us assume a work order issued for the manufacture of 100 pieces of oak veneer of specified thickness and other measurements. Since the logs require steaming before they are ready for the veneer machine there will be two sets of tickets used before completion of the order. The first set will be used

in bringing the logs into the mill, scaling, sawing, barking and steaming. The second set will be used in taking the logs from the steam vat, turning off strips of veneer, cutting the strips into lengths, running them through the dryer, sorting on the trucks, taking the count and transferring to the stock room.

When work is started on the order the superintendent takes a time and material ticket, enters thereon the work order number, the workman's name or number and the operation, with the date. In columns or spaces provided on the ticket the workmen will enter the time started and stopped and the number or class of machine used, if a machine is used. If more than one machine is used by a workman, the time started and stopped should be entered for each machine.

The only material used which will enter into the product under the first set of tickets will be logs. In order to account for this material a tally sheet should be provided and the number of feet in each log that is brought in for the work order should be entered thereon. Of course, this will necessitate scaling each log as it enters the mill. The information shown on this tally sheet is to be transferred in total to the time and material ticket of the workman who saws the logs, entering it in space provided for withdrawn from stores.

Under the second set of tickets the man and machine hours should be accounted for in the same manner as under the first set. The man in charge of the dryer or his assistant should be provided with a production card. As the veneer is taken from the dryer and piled on trucks the defective and broken pieces should be sorted out and record should be made on the production card showing the number of pieces finished, both perfect and defective. When the work order is completed the total number of pieces finished as shown by this production card is to be transferred to the time and material ticket of the workman in charge of the dryer, entering the information in space provided for "pieces finished" or "pieces defective." It probably would be advisable to have the log tally and production sheets turned in to the superintendent for transferring totals to tickets rather than to depend upon the workmen. The time and material tickets are turned in to the superintendent daily.

The superintendent, having entered the information from the tickets on his copy of the work order, turns them over to the bookkeeper, who enters the man rate per hour at the head of the ticket, man rate including overhead in the man-rate column, machine rate in the machine-rate column, the total cost per hour in the rate column and prices of material withdrawn from stores in the space provided therefor. The total cost amount of labor and material is then computed and carried out for entry on the office copy of the work order.

The bookkeeper should enter on the stores card the record of units of material withdrawn. This stores card, of course, furnishes information as to the cost price to be entered on the ticket. Having made the stores card record the bookkeeper should refer to the office copy of the correspondingly numbered work order and enter thereon the date started, total labor cost and material cost.

In order to obtain a general summary of the time and material tickets, from which debits and credits to the general ledger may be recorded, a distribution record should be provided. This record may be called "time and material distribution record." Headings of columns in this record should be date, ticket number, work-order number, in-process amount, "A" expense, "B" expense, "C" expense, "D" expense, sundries, stores and material, man hours cost, amount man overhead, machine overhead, man number or name and time.

In further explanation of the time and material distribution record, the ticket number column is to contain a complete series of numbers for each day's tickets, commencing with No. 1. The in-process amount column is to contain the total cost of time and material shown by the ticket chargeable to a work order. The total of this column at the end of each month should be posted to the debit of in-process account in the general ledger. The columns headed "A," "B," "C" and "D" should contain the total cost which is chargeable to one or more of the expenses represented by those letters and monthly totals of the columns should be posted to the debits of their accounts in the general ledger. The sundries column should contain the total cost of any ticket chargeable to such accounts as new machinery, tools and building improvements. All items in this column should be posted at the end

of each month to the debit of the accounts designated. The stores column should contain the total cost of material drawn from stores as shown by the tickets; and at the end of the month the total of the column should be posted to the credit of stores account in the general ledger. In the man-overhead column should be entered the amount of the man overhead computed according to the cost on the ticket. For example, assume the man-overhead rate per hour to be 20 cents and the time worked three and one-half hours—the man overhead shown on the ticket would be three and one-half times 20 cents. At the end of a month the total of this column should be credited to overhead account in the general ledger. In the column headed machine overhead should be entered the machine overhead amount computed according to cost on the ticket, and the total of the column should be posted each month to the credit of overhead. In the columns headed "man number or name" the total hours each day that a man has worked should be shown, furnishing the information for entering time in the payroll book.

It has already been shown how the labor and material information accumulates from the tickets. When the superintendent reports the order completed the material and labor costs which have been entered on the office copy of the work order should be added together and divided by the total pieces finished, to show the aggregate cost and per piece cost to be entered on the stores card, properly headed. When the cost is entered on the stores card the word "entered" should be written on the work order and the work order should be filed in its proper series location in a cabinet.

The totals of all in-process cards thus closed into stores should be footed each month and the total posted to the debit of stores account and to the credit of in-process account. It is thus evident that all active work orders representing the stock in process will be combined in the office and that the totals of cost values on these cards in aggregate should correspond with the amount shown by the in-process account in the general ledger.

In fixing the per hour overhead cost charge to manufacturing, estimates are necessary when first starting the system. To illustrate the method of obtaining these estimated figures assume the following:

Overhead expense, including indirect labor for 1 year,......	$40,000
Sales, 1 year..	360,000

Number of workmen necessary to produce $360,000 sales value of finished product in a year.......................... 50 men
Number of eight hour days necessary to work.............. 250

Multiplying the number of days by the hours per day and again multiplying by the number of men working result in 100,000 direct hours. Estimating one-half the burden to be machine overhead and that machines are in operation one-half the time, the resulting rates would be 20 cents per hour man rate and 40 cents per hour machine rate. The machine rate should be distributed over the different classes of machines. For example, class A machines may require a rate of 15 cents and class B machines a rate of 25 cents, depending upon the size of the machine, constancy of use, investment, etc. At the end of the first month's operation, or as soon as definite figures can be obtained, adjustment of these man and machine overhead rates should be commenced in order that they may be brought as nearly as possible into accord with actual results instead of estimates. By the end of a year the rates should be established so that they will very nearly absorb the overhead charges. Of course, if the factory operates under minimum production capacity, it will be necessary to make allowance for this in fixing rates. Under such conditions part of the overhead would be chargeable to under-capacity loss and should not be carried into cost of the product.

Besides finished and in-process merchandise stock, the stores cards should show the amount on hand and cost value of all articles and material used in the factory. When invoices are received and approved the merchandise represented therein should be entered on the stores cards in the manner indicated by the card headings. Withdrawal of stock has already been explained.

The stores cards should be frequently proved by counting the material in stock. There will always be discrepancies of more or less amount between the actual amount of stores and the amount shown on the cards. These differences should be immediately rectified by changing the card figures after carefully rechecking the count.

At the close of any period the amount by which the stores cards' aggregate balance total disagrees with the general ledger stores amount should be adjusted by crediting or debiting stores and contra debiting or crediting adjustment account.

Sales should be recorded by means of the duplicate bill system. Upon the duplicates the bookkeeper enters the cost values of all items and totals them. The duplicates are then entered in the sales register. In the sales register the total amount of the bill as charged to the customer is entered in the sales column. The total cost is entered in the cost-of-sales column. The total of all material or merchandise that was withdrawn from stores is entered in the stores column. Any articles that come from other sources, such as machinery and tools, should be entered in the sundries column, and the account, such as machinery and tools, should be indicated.

The monthly total of the sales column should be entered to the debit of accounts receivable and to the credit of sales account in the general ledger. The monthly total of cost-of-sales column should be entered to the debit of cost-of-sales account in the general ledger. The monthly total of stores column should be entered to the credit of stores account in the general ledger. All items in the sundries column should be entered to the credit of the various accounts indicated.

In a complete discussion of accounts and costs for the manufacture of wood veneer there would be many details which have not been mentioned in this paper, but it is believed that the important features have been sufficiently explained to enable any minor problems that might arise to be worked out with comparative ease. The cost data brought together would be invaluable in fixing prices, and the summarized figures in the monthly statements from the general ledger containing such information as cost of sales, overhead, under-capacity loss, etc, would afford an interesting and profitable study for the manufacturer who is endeavoring to learn how to direct the course of his business and prevent waste.

Accounts of Instalment Furniture Dealers*

By Henry G. Greenfeld

The income-tax regulations (article 42 of regulations 45) permit dealers engaged in the sale of furniture on the instalment plan to determine their incomes by

1. considering the gross profit on an instalment sale as realized at the time the sale is effected, or
2. considering only such part of the gross profit on an instalment sale as realized as is collected in cash.

As no particular problems present themselves in keeping accounts in accordance with the first method, this discussion will be confined to the dealer keeping his accounts according to the second method.

The original record of sales is the order sheet prepared by the salesman making the sale. The order sheet should be prepared in duplicate so that the original may serve as an office copy and the duplicate as a combination shipping order and delivery receipt. Should it be desired to supply the customer with a copy of the order, it would, of course, be necessary to prepare the order in triplicate, but this is not a customary practice in the trade.

The sales subdivide themselves into three classes: cash sales including C. O. D. sales, charge sales and instalment sales.

Cash and C. O. D. sales may both be entered in one cash sales register, which should have column headings to show

1. Register number
2. Date
3. Customer
4. Address
5. Date to deliver
6. Amount of sale
7. Cash sale
8. Deposit

* A thesis presented at the May, 1920, examinations of the American Institute of Accountants.

9. Balance due
10. Date delivered
11. Balance collected

Should the C. O. D. sales, however, be numerous, it would be advisable to keep them in a separate C. O. D. register. In handling cash and C. O. D. sales the sales should be registered, the cash turned over to the cashier and the sales slips stamped so as to show whether they are cash sales or C. O. D. sales. The original slips should then be turned over to the bookkeeping department and the duplicates to the shipping department.

In the case of charge and instalment sales, the credit department will be called to pass on the sale before any further action is taken. Should this department approve the sale, notation of that fact should be made on all copies of the sales order; the necessary leases or mortgages should be drawn, signed by the customer; the sale should be registered in the charge and instalment sales register; and any cash deposit on the sale should be turned over to the cashier. The duplicate copy of the sales order may then be turned over to the shipping department and the original to the bookkeeping department. The charge and instalment sales register should be headed to show

1. Register number
2. Date
3. Customer
4. Address
5. Date to deliver
6. Amount of sale
7. Charge sale
8. Instalment sale
9. Deposits on sales
10. To collect on sales
11. Date delivered
12. Amount collected

The sales should be checked against the shipping orders and the records of the shipping department as well as the cashier's record regularly, so as to complete the record as contained in the sales registers.

Upon receipt of the duplicate shipping order, the shipping department should call for the furniture from the stock clerk

and prepare the necessary route lists. Should the stock clerk be unable to supply all the furniture required, that fact should be noted on the original shipping order and a short-shipment ticket in duplicate should be prepared, one copy of which should go to the office and the other be retained by the stock clerk until the furniture becomes available and is shipped.

There should be kept in the shipping department a continuous record of all shipments made, showing

1. Date
2. Cash sale register number
3. Charge and instalment sale register number
4. Name
5. Address
6. Amount to collect
7. Name of driver
8. Time left
9. Receipt returned
10. Remarks

Should any shipment be refused by the customer, notation should be made by the driver on the shipping order and turned in to the shipping department, which should cause to be prepared a credit memorandum covering the items refused. This credit memorandum should be checked by the stock clerk at the time he replaces the furniture in stock and should be approved by some one in authority before being passed to the books. This department should prepare daily and turn in to the office a list of all shipments made and C. O. D.'s collected.

Detail records should also be kept in this department of loads carried by individual trucks, miles run and cost of operating the trucks so as to form a basis for comparison of the work done by the several trucks in use.

No merchandise should be accepted for return except when authorized by the issuance, by the office, of a "bring-back" ticket. Returns of current year sales should be segregated from defaults and returns of prior year sales and be entered in a return register.

The handling of defaults, allowance and returns of prior years

is a troublesome one, as it is necessary to assemble the following information with respect to each entry.

1. Amount of sale
2. Cost of goods sold
3. Amount of profit to be realized
4. Cash collections prior years, yearly
5. Cash collections current year
6. Profits reported in prior years, yearly
7. Amount to be charged to unrealized gross profits on instalment sales
8. Present value of merchandise repossessed
9. Amount to be charged to realized profits on instalment sales
10. Amount to be credited to customer

By indicating the above on each credit memorandum, however, it becomes possible to summarize the totals in a special defaults journal and place the facts on the books. The defaults journal should be headed as follows:

1. Date
2. Credit memorandum register number
3. Name
4. Folio
5. Amount of sale
6. Cost of goods sold
7. Amount of profit to be realized (col. 1-2)
8. Cash collections prior years
9. Cash collections current year
10. Profits reported in prior years
11. Amount to be charged to unrealized gross profit on instalment sales (col. 7-10)
12. Present value of merchandise repossessed
13. Amount to be charged to realized profits on instalment sales (col 6 + 10 — (col 8 + 9 + 12)
14. Amount to be credited to customers (col 11 + 12 + 13)

The cash records consist of the collectors' daily and weekly reports, cashier's daily sheets, the cash receipts book and the cash disbursements book. Collectors should be required to turn in a daily report with their cash collections. These reports after

being checked by the cashier should be numbered consecutively, listed in the cashier's daily sheets and turned over to the bookkeeping department before being filed permanently. In addition, collectors should be required to turn in a weekly report covering total cash collected by them during the week. This report should be handed in either to the collection or credit manager, dependent on which one is in charge of collections, so as to enable him to judge the ability of the collectors. The cashier's sheets which contain a complete record of all cash collections made by the collectors should be numbered consecutively, proven with the daily deposit, summarized in the cash receipts book, and then turned over to the bookkeeping department. Cash registers in the cashier's department will be found useful and will provide an additional safeguard for the cash.

The cash receipts may be audited by comparison of the daily deposits with the daily receipts and a check of the cashier's sheets against the collectors' daily and weekly reports, the cash sales register, the charge and instalment sales register, the original sales slips, the cash register and the shipping department records.

The cash disbursements book is a simple one and does not require any particular comment.

With reference to the charge and instalment accounts, it is important that they be kept posted continuously up-to-date. When posting sales to these accounts, "soft sales," i. e. sales of soft goods, which have very little value in case of default, should be distinguished from "hard sales," so as to guide the credit department as to the extent it may press delinquent customers for payment. Postings to the customers' accounts should, in the case of sales, be made from original order sheets; in the case of cash collections from cashier's sheets and collectors' reports; in case of returns, from credit memoranda; and in case of cash refunds from cash refund authorizations. Posting machines will be found of great value in this class of work because of the large volume of the postings and the need of proving quickly.

In the case of the instalment accounts, it will also be found desirable to maintain controlling accounts for each one or two thousand accounts. These controlling accounts need not be kept on the general ledger but may be kept in a memorandum record

supporting the instalment accounts controlling account on the general ledger.

After all postings to the customers' accounts have been made for the day, the accounts affected by the day's postings should be compared with the collectors' cards and the latter should be brought into agreement with the ledger accounts. Should any of the collectors' cards not be on hand, notation of postings and balances due may be made on a blackboard in the collectors' room or a report should be drawn up and posted in the collectors' room so that the collectors may be able to bring their cards up to date when they come in.

Refunds should not be made except on the authority of either the credit department or the store manager or an assistant to whom the power has been delegated, nor should a cash sale or C. O. D. sale be cancelled except on similar authority. If this rule be not observed, serious abuses may develop.

Purchase bills should be compared with original orders and the receiving records before being approved for entry. It will be best for the receiving department records to be constructed without reference to either bills or lists of the merchandise expected, as otherwise there will be a tendency to pass the merchandise received without a proper count.

Both purchase and expense bills may be entered in a voucher register and the vouchers may be prepared in duplicate so that one may serve as an office record and the other as a pay statement. At the time the vouchers are drawn care should be taken to prepare separate vouchers for bills of different maturities. All vouchers entered should be settled by cheque. Current cash receipts should not be used for this purpose. The audit of purchases and expenses may then be made by comparing the approved vouchers and the bills attached with the receiving department records, the voucher register and copy of original orders placed and checked against the cash records for payment. Small incidental expenses should be paid out of a petty cash fund, which should be replenished from time to time by passing through a voucher for expenditures made.

Excepting the item of unrealized gross profits on instalment sales, the assets and liabilities of instalment dealers are similar to the assets and liabilities of other retail dealers. The item

unrealized gross profits on instalment sales represents the amount of profit to be realized on instalment accounts appearing as an asset on the balance-sheet when collected in cash.

The expenses of instalment dealers do not differ materially from the expenses of other retail dealers, with the one exception that collection expenses are much higher. With respect to income, however, special treatment is required.

For this purpose the sales are divided into two classes

Class 1. includes cash sales, charge sales and instalment sales on which an initial payment of 25 per cent or more is made.

Class 2. includes all other instalment sales.

To determine the gross profits to be taken into income, it is necessary to include all the gross profit on sales of class 1 and that proportion of gross profit on sales of class 2 which is realized by cash collection.

The first step to be taken is to determine the cost of the goods sold and the proportion of that amount which should be charged against each of the two classes of sales. Should no records covering this distribution be available, it may be pro-rated on the basis of sales.

The application of the cost of the goods sold against the sales of class 1 gives the gross profit on sales of class 1.

With respect to class 2, however, the difference between the sales and the cost of the goods sold is the amount of unrealized gross profit on instalment sales.

Journalized the above entries would read:

1. Sales class 1	$......	
To cost of goods sold		$......
Profit and loss sales class 1		$......

To close the above accounts and determine gross profit thereon.

2. Sales class 2	$......	
To cost of goods sold		$......
Unrealized gross profit on instalment sales		$......

To close the sales account into its component parts.

The second step is to determine the amount of unrealized gross

profits on instalment sales which has been realized. To do this, it is first necessary to ascertain the cash collections on instalment accounts, including collections on instalment sales of prior years, and then to take that proportion of the cash collections which the amount credited to unrealized gross profits on instalment sales, as shown by journal entry 2, bears to the sales shown in the same entry. Before taking the proportion of cash collections shown above, however, there should be excluded from cash collections the amount collected during the current year on defaulted accounts. This step may be journalized as follows:

3. Unrealized gross profit on instalment
   sales $......
   To realized profits on instalment
   sales $......
   For......per cent of cash collections on instalment accounts for year realized, collections.....

The third step is concerned with the handling of defaults, returns etc.

Treasury regulations provide that when the vendee defaults and the dealer is unable to recover personal property sold, the dealer should report as a loss the difference between the total amount actually received and the cost of the goods sold plus the amounts returned as profit from sales in former years. Should the dealer recover the personal property sold, his loss would be decreased by the present value of the property recovered. Assuming, then, a case in which the dealer recovered personal property, the entry appearing on his books would read

4. Property repossessed	$......	
Unrealized gross profit on instalment sales	$......	
Realized profits on instalment sales	$......	
To accounts receivable		$......
For amount of default		
Cost of goods sold	$......	
Amount returned as profits in prior years	......	
Total	$......	

Amounts recovered	$......	
Merchandise repossessed	......	$......
Amount chargeable to realized profits on instalment sales	$......	
Unrealized gross profit on instalment sales	......	
Amount to be credited to customers	$......	

Returns of current year's sales and allowances thereon should be charged against the sales account before applying the cost of goods against that account.

The stock records should be kept on cards and should be arranged so as to show

1. Name of manufacturer
2. Manufacturer's number
3. House number
4. Description
5. Purchase order number, date and quantity ordered
6. Date, voucher number and quantity received
7. Cost price, which usually is in code
8. Date, sale number and quantity sold
9. Balance

As stock is normally held in part at the retail store and in part at one or more warehouses, it is best to have a different colored card used for each place at which merchandise is stored. Transfer slips should be used to cover shipments from one place to another.

The finding of customers' names and addresses sometimes presents a peculiar problem. This is especially true of dealers selling to non-English-speaking customers, who frequently possess names which do not sound as they are spelled or are unable to pronounce their names with sufficient distinctness to enable one to find them in the ordinary index. This difficulty may be overcome by keeping a

special index arranged by towns and streets, as such customers usually are able to give their addresses. In keeping an index of this kind, a new card should be placed in the files every time a customer changes his address, but the old one should not be disturbed, as past experience shows that customers sometimes remember old addresses and not the new.

The Journal of Accountancy

Published monthly for the American Institute of Accountants by
The Ronald Press Company, 20 Vesey Street, New York, N. Y.
Thomas Conyngton, president; L. G. Henderson, secretary;
Hugh R. Conyngton, treasurer

A. P. RICHARDSON Editor

EDITORIAL

Breaking In

From time to time it seems to be necessary for The Journal of Accountancy to discuss the question of breaking into the accounting profession. Innumerable inquiries are received by letter or word of mouth as to the proper course of action to be pursued by a young man or a young woman who desires to enter public accounting and has no preliminary experience upon which to base a claim for consideration.

We have endeavored to discuss this question with absolute fairness to both sides, but it may not be amiss to revert to it.

The following letter is a specimen of the complaints which are made in regard to the difficulty of entering the profession.

Editor, The Journal of Accountancy:

Sir:—Several times on various occasions I have read articles in The Journal of Accountancy by prominent accountants of the United States which lamented the fact that young men of to-day were not going into the accounting profession in larger numbers. The articles spoke of the dignity of such a calling, the pecuniary advantages, and the opportunity of exercising every ounce of a man's ingenuity and ability. It was a "fitting field" for brainy men.

Yet I honestly believe with all sincerity that these writers are doing one of two things—either they are closing their eyes to the true state of affairs or they are trying to deceive both themselves and the accounting profession in general. This is the reason why:

Correspondence schools teaching accountancy are continually emphasizing the fact that accountancy students are in great demand at fancy salaries. The above-mentioned letters would seem to substantiate the facts. Young men by the scores enroll in the course on the strength of this statement. When they have reached a certain point they feel that they should have practical experience along with the theoretical. They apply for work in a public accountant's office, stating they are willing to do most any kind of work to get the experience, if a decent living wage is offered them.

Yet time after time, with disheartening regularity, they are told that if they were experienced men they could be used, but in the circumstances an

inexperienced man would be too expensive an investment. Always they must be experienced to land a job; but where in the name of Heaven are they to get the experience—the start? You forget your start, and the fact that every man must make a beginning.

And then you turn around in the next breath, and say, dolefully: "Why don't young men come into the profession?"

Large corporations to-day are conducting industrial schools for the purpose of educating their workers by the hundreds. They wouldn't do it if it didn't pay. Yet public accounting firms large enough to have branches in nearly every large city in the United States can't afford to take one man into training because of the expense incurred. Personally, if I were an accounting executive I would be on the lookout for wide-awake, ambitious young men who were really anxious to get into public accounting. I would consider it part of my job as an executive.

To get down to personal cases: I wrote the following letter to 18 C. P. A.'s of this city. I received answers from two, one stating he had nothing of interest to me, the other stating that he could use me if I were experienced. The others did not have courtesy enough to reply:

Is This of Value to You?

Dear Sir:

1. Young man—26 years old—university education.
2. Commissioned officer in the army during the war.
3. Wide experience in general clerical work.
4. Recent special training in auditing department of large industrial corporation with whom he is still employed.
5. Experienced in handling general ledger and controlling accounts.
6. Special training in higher accountancy by reason of course with large correspondence school.
7. Ambitious and determined to become a C. P. A., and desirous of connecting with a public accounting firm in any capacity.
8. As evidence of sincerity he is willing to leave his present position. Present salary a secondary consideration if given a chance to make good.
9. References furnished on request.

I believe these qualifications should be of value to you. Would be glad to call on you personally if you will write or 'phone me at the address shown below.

* * * * *

I am not basing my observations on this one experience. I have tried before to break into the accounting field, with the same result. And I know personally other young men who have had the same experience.

Don't misunderstand me. I am not railing against fate because I can't land a job. I have a good job with a good company, and would probably have to start in accounting work at a lower salary. But I want to do public accounting work, and will do it if given a chance. What I am concerned with is the hypocritical remarks of certain prominent accountants in attempting to give the idea that young men are not trying to get into the accounting profession.

If correspondence schools are misrepresenting the facts when they state that accountancy students are in great demand, then the American Institute of Accountants is a large and powerful enough body, with enough influence to see that such advertising is stopped.

Yours truly,

Los Angeles, July 22, 1920. C. A. H.

P. S.—I would be grateful if you could find it possible to publish this letter, in order that practising accountants may justify their position, if they care to. C. A. H.

There are several statements in this letter which are the result of obvious misunderstanding. For example, we doubt if any reputable member of the accounting profession would attempt to excuse the flamboyant and utterly misleading advertising of some so-called correspondence courses in accounting. Many of the advertisements are so ridiculous in their claims that we have not much sympathy for anyone who is deceived by them.

The experience of the author of the letter in failing to obtain employment may be due to circumstances of which we have no knowledge whatever. It is absurd to express himself as he does in regard to the failure of accounting offices to reply to his circular letter. If every business office were to attempt to reply to all circular letters which are received, the profit to the United States mails might be considerable, but the loss to business would be incalculable. Most circular letters find their way to their deserved destination in the waste basket.

Our correspondent's argument on another point is unfortunate. If every large accounting firm in the country were to take one man into its employ the number of accessions to the accounting profession in the course of a year would not be sufficient to cause any general labor shortage in other vocations.

There is, however, force in the argument that the young man without experience is not always wanted in an accountant's office. Many firms do what our correspondent seems to think is not done—there is many a man employed by accountants and carried on the payroll for months without being worth anything to the employer. Indeed, it is doubtful if there are many accounting offices in the country in which men are not being trained from the kindergarten stage upward. The difficulty of breaking in nevertheless exists, and, frankly, it is hard to see how that difficulty can be entirely overcome. An apprentice in a British office serves five years without compensation and generally pays a premium for the privilege. Presumably before the close of the five years he is of some value to his employer. It is certain that when the five years are ended he must have demonstrated either his utter unfitness for the profession or his ability to practise.

It is absolutely true that there is always a scarcity of qualified men for public accounting work. Even in the dullest days of the year a good senior accountant should have no difficulty in finding employment in an accounting office.

But what shall be said of the young man' starting, as our correspondent appears to be?

On his own showing he is entirely without experience; his value to prospective employers is problematical; his fitness for the accounting profession is unknown—in such circumstances is it astonishing that there is no great desire to afford an opening?

The easiest solution of the problem would be the introduction of the apprenticeship system, but, of course, every American knows that the serving of articles is entirely repugnant to the American idea. We shall never see its introduction here.

In the absence of a solution of the problem the best advice we can offer is of no great value, but this may be said without fear of contradiction: that the young man and possibly the young woman (although the chances are less likely in the latter case) who has fundamental theoretical knowledge, adequate education and attractive personality can generally find an opening in the vocation which he or she desires to enter.

There are ways of seeking entrance which are almost certain to fail. There are others which are nearly as certain to succeed. The record of our correspondent indicates a fair amount of desirability. We shall be much astonished if some of our readers do not write and ask us for his name and address—and that will be a refutation of his charges.

Misuse of Accountants' Certificates

A recent issue of The Journal of Accountancy contained editorial comment on the misuse of accountants' certificates. Attention was drawn to the danger which lies in the publication of a portion of a certificate or financial statement without the context.

The most notorious incident on record of the perversion of the written word by omission is Bismarck's mutilation of the Ems dispatch which induced the Franco-Prussian war. All decent men everywhere damn the iniquity of that offense; yet many overlook the comparatively unimportant criminality which attaches to the omission of essential statements in a financial report. Such an offense seems insignificant compared with an international incident, but the principle or lack of principle is the same. No essen-

tial phrase or word or punctuation mark should be omitted if by such omission the intent of the writer is distorted.

Accountants are awaking to the danger which lies in condensation of their reports and some of them are insisting upon a clear, full reproduction of their original certificates and statements.

A method adopted by one prominent firm is worthy of consideration. Every report emanating from that firm bears the following printed note:

> "The publication of any condensation or modification of statements herein contained, or the use of our certificate detached from its context, or the use of our name in connection with the sale of securities or other publicity will not be sanctioned unless first submitted for our approval."

This limitation upon the use of an accountant's report if generally adopted would go far to prevent deception of the public such as is too easily effected if financial statements be published in any form not fully reflecting the facts.

Income-tax Department

Edited by Stephen G. Rusk

Treasury decision 3029, set forth below, must relate to taxation under the revenue act of October 3, 1913, only.

The law which permits the government to tax income from isolated transactions of a taxpayer entered into for profit but does not permit deductions for losses sustained in such transactions has caused much adverse criticism.

Judge Grubb makes the observation in rendering his decision in the case of *Eugene W. Mente vs. Mark Eisner, Collector of Internal Revenue,* that "tax laws are not required to be perfect or even consistent." That the revenue act of 1913 was not perfect nor consistent in its provisions is a fact that has generally been accepted, but because of the comparatively low rates of taxation in effect at that time no great amount of protest was made against its unjust provisions.

When it is remembered that one particular imperfection in the law of 1913 was recognized at once by all whose taxes were affected by the defective language, and when it is remembered also that the revenue acts of 1916-17 and of 1918 rectified this imperfection, by allowing taxpayers to deduct losses sustained in "transactions entered into for profit but not connected with the business or trade," it is difficult for the laity to understand why a court decision made as lately as May 3, 1920, should adhere so closely to a treasury decision of October 14, 1914.

It is obvious that those responsible for the 1914 treasury decision confined themselves strictly within the most limited interpretation of the language of the act under consideration without regard for its imperfections. That the department was inspired by the highest motives is acknowledged without argument, but it would seem that administrative discretion should have been considerably extended, to the end that grave injustice might not be wrought by an interpretation so narrow.

We have no intimate knowledge of the facts in the *Mente vs. Eisner* case, and our observations are not made with specific reference to it. We are thinking only of the principle involved.

That this decision of Judge Grubb relates only to the revenue act of 1913 is shown by the following excerpts from the regulations (No. 33) appertaining to the 1916-17 revenue act and section 214, paragraph 5, of the revenue act of 1918.

Article 8, fifth paragraph of regulations No. 33, of the 1916-17 law, setting forth that which is properly deductible from gross income, reads as follows:

"Losses actually sustained during the year in transactions entered into

for profit but not connected with his business or trade to the extent of but not exceeding the profits arising from such transactions."

Section 214 (a), paragraph 6, of the revenue act of 1918, under the heading "deductions allowed," reads as follows:

"Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business; but in case of a nonresident alien individual only as to such transactions within the United States."

From the above it is evident that Judge Grubb's decision has no effect upon tax returns made for any taxable year beginning with or since January 1, 1916, and it is also evident that, in the passage of the later law, congress recognized the inconsistency in the former law.

Treasury decision 3029 follows:

(T. D. 3029)

Income tax

Section 214 (a), 4, 5, 6, Article 141: Losses

Income Tax: Act of October 3, 1913, Section II—Deductions

1. A member of a firm engaged in the business of manufacturing is not entitled to deduct from his gross income a loss sustained by him upon the sale of shares of stock.

2. The language "losses incurred in trade" must be construed as meaning losses incurred in the actual business of the taxpayer as distinguished from isolated transactions.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND DISTRICT

Eugene W. Mente, Plaintiff in Error, vs. Mark Eisner, Collector of Internal Revenue, Defendant in Error.

[May 3, 1920]

Ward, circuit judge: Section II, subdivision 2 (b), of the act of October 3, 1913, provides that in computing net income for purposes of normal tax there shall be allowed as a deduction:

* * * Fourth: losses actually sustained during the year incurred in trade, or arising from fires, storms or shipwreck and not compensated for by insurance or otherwise.

Mente, a member of the firm of Mente & Co., engaged in the business of manufacturing jute bags and bagging, cotton bags, and materials for covering cotton bales, filed his income returns for the year March 1 to December 31, 1913, and for the whole year of 1914. He had for some three years been buying and selling cotton on the cotton exchange for his individual account, in no way connected with the business of Mente & Co., and he deducted from his gross income in each year losses sustained in the year resulting from these transactions as "losses incurred in trade."

Eisner, as collector of internal revenue for the third district of the state of New York, assessed an additional tax upon these deductions, which Mente paid under protest, taking an appeal to the commissioner of internal revenue under sections 3220 and 3228, *United States Revised Statutes,* and the regulations of the secretary of the treasury in pursuance thereof, who rejected his claim. Thereupon Mente began this action against Eisner as collector to recover the amounts so paid, with interest and costs.

Treasury decision 2090, dated October 14, 1914, reads:

Loss, to be deductible, must be an absolute loss, not a speculative or fluctuating valuation of continuing investment, but must be an actual loss, actually sustained and ascertained, during the tax year for which the deduction is sought to be made; it must be incurred in trade and be determined and ascertained upon an actual, a completed, a closed transaction. The term "in trade," as used in the law, is held to mean the trade or trades in which the person making the return is engaged; that is, in which he has invested money otherwise than for the purpose of being employed in isolated transactions, and to which he devotes at least a part of his time and attention. A person may engage in more than one trade and may deduct losses incurred in all of them; provided that in each trade the above requirements are met. As to losses on stocks, grain, cotton, etc., if these are incurred by a person engaged in trade to which the buying and selling of stocks, etc., are incident as a part of the business, as by a member of a stock, grain or cotton exchange, such losses may be deducted. A person can be engaged in more than one business, but it must be clearly shown in such cases that he is actually a dealer, or trader, or manufacturer, or whatever the occupation may be, and is actually engaged in one or more lines of recognized business, before losses can be claimed with respect to either or more than one line of business, and his status as such dealer must be clearly established.

Both parties having moved for the direction of a verdict, Judge Grubb directed a verdict in favor of the defendant.

We think that the language "losses incurred in trade" are correctly construed by the treasury department as meaning in the actual business of the taxpayer as distinguished from isolated transactions. If it had been intended to permit all losses to be deducted it would have been easy to say so. Some effect must be given to the words "in trade."

There is an inconsistency in making profits derived from such transactions a part of the taxpayer's gross income and on the other hand allowing him no deduction for losses. But tax laws are not required to be perfect or even consistent. It must be determined from the facts in each case whether or not the losses claimed to be deducted have been incurred in a business.

In this case the court must be taken to have found as matter of fact that these transactions in 1913 and 1914 did not constitute a business. Such a finding is binding upon us.

Judgment affirmed.

Treasury decisions 3030 and 3031 amend and amplify the regulations concerning withholding taxes at the source, and comment upon them perhaps is superfluous.

Section 256, article 1078 (a): Foreign items presented for collection unaccompanied by ownership certificates. T. D. 3030

The final edition of regulations 45 is amended by inserting immediately after article 1078 an article which will be known as article 1078 (a), as follows:

ART. 1078 (a). *Foreign items presented for collection unaccompanied by ownership certificates.*—If the foreign item is an interest coupon detached from bonds containing a tax-free covenant clause, issued by a foreign country or corporation having a paying agent in the United States, an affidavit and ownership certificate, form 1000, revised, shall be furnished as provided in article 368.

In the case of other foreign items which are received unaccompanied by an ownership certificate and the owner is unknown, an affidavit shall be required of the payee, showing the name and address of the payee, the name

and address of the debtor organization, the date of the dividend cheque or the maturity of the interest coupon, the name and address of the person from whom the dividend cheque or interest coupon was received, and a statement that the owner of the securities is unknown to the payee. The first bank receiving such foreign item shall prepare a certificate of ownership, form 1001A, revised, crossing out the word "owner" and substituting therefor the word "payee." The first bank shall stamp or write across the face of the certificate "affidavit furnished," adding the name of the bank. Thereupon the affidavit and certificate shall be forwarded to the commissioner as provided in article 1079.

Section 256, article 1078: Ownership certificates for foreign items. T. D. 3031

The final edition of regulations 45 is amended by amplifying article 1078 so as to read as follows:

ART. 1078. *Ownership certificates for foreign items.*—(*a*) When bonds of foreign countries, or bonds or stocks of non-resident foreign corporations, are owned by citizens or residents of the United States, individual or fiduciary, by domestic or resident foreign corporations, or partnerships, or by personal-service corporations, ownership certificate, form 1001A, revised, shall be executed by the actual owner or by his duly authorized agent when presenting the item for collection, whether such item is a dividend or an interest payment, except in the case of a foreign country or a foreign corporation having a fiscal agent or a paying agent in this country and issuing bonds which contain a tax-free covenant clause. In such a case the fiscal agent or paying agent is required to withhold the normal tax of 2 per cent from the interest on such bonds and ownership certificate, form 1000, revised, modified to show the name and address of the fiscal agent or the paying agent, should be used, unless the owner (if so entitled) desires to claim exemption, in which case form 1001A, revised, should be filed. (*b*) When such foreign bonds or stocks are owned by non-resident alien individuals, corporations or partnerships, ownership certificate, form 1001A, revised, shall be used on behalf of such owners by any responsible bank or banker, either foreign or domestic, having knowledge of such ownership. In such a case the bank or banker need not fill in the names of the owners.

Treasury decision 3032, simply makes more definite the latest date possible for notification to the collector for transmission to commissioner of the change of a taxpayer's accounting period. The amendment to article 26 of regulations 45, consists of a change in the language of "(b)" of that article.

It formerly read as follows:

> "At least thirty days before the due date of his return on the basis of the proposed taxable year."

It is amended to read as follows:

> "At least thirty days before the due date of his separate return for the period between the close of the existing taxable year and the date designated as the close of the proposed taxable year. The due date of the separate return for such period is the fifteenth day of the third month following the close of that period."

The full text of the decision follows:

Section 212, article 26: Change in accounting period. T. D. 3032

ART. 26 of regulations 45 is hereby amended to read as follows:

ART. 26. *Change in accounting period.*—If a taxpayer changes his ac-

counting period, and not merely his taxable year to conform with his existing accounting period, he shall as soon as possible give to the collector for transmission to the commissioner written notice of such change and of his reasons therefor. The commissioner will not approve a change of the basis of computing net income unless such notice is given at a time which is both (*a*) at least thirty days before the due date of the taxpayer's return on the basis of his existing taxable year, and (*b*) at least thirty days before the due date of his separate return for the period between the close of the existing taxable year and the date designated as the close of the proposed taxable year. The due date of the separate return for such period is the fifteenth day of the third month following the close of that period. If the change in the basis of computing the net income of the taxpayer is approved by the commissioner, the taxpayer shall thereafter make his returns upon the basis of the new accounting period in accordance with the requirements of section 226 of the statute, and his net income shall be computed as therein provided. See article 431.

Treasury decision 3037 promulgates a decision of the supreme court of the United States that the salaries of the president and federal judges are not subject to income tax, on the ground that the laying of such tax upon these salaries is not in accordance with the constitution.

The decision is only interesting to accountants as a matter of information, and as the full text of the decision is too voluminous for publication in The Journal of Accountancy a brief summary only is presented:

(T. D. 3037)

Income tax—Decision of Supreme Court

1. Taxability of Salaries of President and Federal Judges.

   Stated in its broadest aspect, the contention involves the power to tax the compensation of federal judges in general, and also the salary of the president.

2. Constitution Prohibits Diminution of Compensation.

   The constitution provides that the judge shall have a sure and continuing right to the compensation, whereon he confidently may rely for his support during his continuance in office, so that he need have no apprehension lest his situation in this regard may be changed to his disadvantage.

3. Purpose of the Prohibition.

   The primary purpose of the prohibition against diminution was not to benefit the judges, but to attract good and competent men to the bench and to promote independence of action and judgment.

4. Prohibition Includes Taxation.

   The prohibition is general, and the reasons for its adoption make with impelling force for the conclusion that the fathers of the constitution intended to prohibit diminution by taxation as well as otherwise.

5. Other Income Not Exempt.

   Apart from his salary, a federal judge is as much within the taxing power as other men are. And, speaking generally, his duties and obligations as a citizen are not different from those of his neighbors. But his compensation as a judge is protected from diminution in any form, whether by a tax or otherwise, and is assured to him in its entirety for his support.

6. Judgment Reversed.

   The judgment of the district court (262 Fed., 550) reversed.

Students' Department

EDITED BY SEYMOUR WALTON*
(ASSISTED BY H. A. FINNEY)

AMERICAN INSTITUTE EXAMINATION, MAY, 1920

In regard to the following attempt to present the correct solutions to the questions asked in the examination held by the American Institute of Accountants in May, 1920, the reader is cautioned against accepting the solutions as official. They have not been seen by the examiners—still less endorsed by them.

ACCOUNTING THEORY AND PRACTICE—PART I

Answer questions 1, 2, 3 and any five other questions.

Question No. 1:

The books of a concern recently burned out contained evidence of purchases, including inventory, of $200,000 and sales of $40,800 since the last closing. Upon investigation, however, the auditor ascertained that a sale of merchandise had been made just prior to the fire, and not recorded in the books, at an advance of two-fifths (2/5) over cost less a 10 per cent cash discount, on which the profit was $31,928.00. The past history of the business indicated an average gross profit of 50 per cent on cost of goods sold.

(a) What amount should be claimed as fire loss?

(b) What rate of gross profit do the transactions finally yield?

Answer to Question No. 1:

There are several elements of uncertainty in this problem. In the first place, the unrecorded sale was made at an advance of 40 per cent over cost, whereas the average gross profit of the past had been 50 per cent on cost. Does this mean that the recorded sales of $40,800 were also made at an advance of only 40 per cent instead of 50 per cent as in former years? Perhaps so, but the size of the unrecorded sale indicates that it was more in the nature of a bulk sale than a normal sale in the regular course of operations. That being the case the rate of gross profit on this sale could be expected to be less than normal.

In the second place, it is possible that the recorded sales of $40,800 were made at a gross profit enough larger than 50 per cent to offset the 40 per cent on the unrecorded sales, and made the average 50 per cent for the period since the last closing. This is highly improbable, because a gross profit of over 400 per cent on the cost of the relatively small recorded sales would be necessary to offset the 40 per cent on the large unrecorded sale and bring the average to 50 per cent. All things considered, it seems fair to assume

* The greater part of the matter for the *Students' Department* for August and September was prepared by Mr. Walton shortly before his death.—*Editor.*

that the profit on the recorded sales averaged 50 per cent as in the past, and that the unrecorded sale was unusual.

In the third place, should the rate of gross profit be computed before or after deducting the 10 per cent cash discount? Accepting the 10 per cent as a true cash discount the rate should be computed before making the deduction; but 10 per cent seems too large to be a true cash discount, and it is therefore considered a reduction of price, and the rate of gross profit is computed after deducting the discount.

(a) Fire loss:

Inventory and purchases..................................			$200,000
Deduct:			
Estimated cost of goods sold:			
Recorded sales	$40,800		
Less estimated profit—1/3 of $40,800	13,600		
Estimated cost of recorded sales...		$27.200	
Unrecorded sale:			
Net cost = 100%			
Then selling price = 140%			
And 10% cash discount = 14%			
And net amount received = 126%			
And profit = 26% = $31,928			
Then 100% = ...		122,800	
Total estimated cost of sales.........			150,000
Amount claimed as inventory.........			$50,000

(b) Rate of gross profit:

(1) Treating cash discount as a reduction of price:

Profit on recorded sales........	$13,600
Profit on unrecorded sales......	31,928
Total profit	$45,528

$45,528 ÷ $150,000 = 30.352%

(2) Treating cash discount as a financial item:

Cost of unrecorded sale........	$122,800
Profit on unrecorded sale.......	31,928
Net amount received..........	$154,728, which is 90% of selling price.

$154,728 ÷ .90 = $171,920 selling price

Add recorded sales....	$ 40,800
Total sales...........	$212,720

Cost of recorded sales—estim'ed.	$27,200	
Cost of unrecorded sales.......	122,800	
Total cost....................	$150,000	
Sales		$212,720
Less cost of sales.............		150,000
Profit		$62,720

$\$62,720 \div \$150,000 = 41.813 + \%$

Question No. 2:

From the balance-sheet of the Landsdale Monotile Company, dated December 31, 1918, as below, together with the information following, show the trial balance before closing.

THE LANDSDALE MONOTILE COMPANY

Balance-Sheet, December 31, 1918

Assets			*Liabilities and capital*	
Land & build'gs.	$500,000		Capital stock............	$300,000
Less reserve for depreciation..	120,000	$380,000	Notes payable...........	350,000
			Accounts payable........	158,000
			Interest accrued payable..	3,000
Machinery and equipment ...	$200,000		Surplus	314,000
Less reserve for depreciation..	80,000	120,000		
U. S. Victory bonds		100,000		
Merchandise — inventory		125,000		
Cash		58,000		
Accounts receivable	250,000			
Less reserve for doubtful accts	12,500	237,500		
Notes receivable		100,000		
Accrued interest receivable ...		4,500		
Total		$1,125,000	Total	$1,125,000

The accruals at the time of closing were:

Interest on notes payable, $3,000; depreciation of buildings, $20,000; interest on notes receivable, $2,000; depreciation of machinery and equipment, $30,000; interest on Victory bonds, $2,500; provision for doubtful accounts, $12,500. The other nominal accounts closed out were: sales, $325,000; administrative expense, $50,000; cost of goods sold, $125,000; selling expense, $25,000.

Answer to Question No. 2:

The trial balance can be obtained by setting up the following working papers, reversing the closing entries:

THE LANDSDALE MONOTILE COMPANY

Working Papers—December 31, 1918

DEBITS	*Balance-sheet*	*Closing entries reversed*		*Trial balance before closing*
Land and buildings	$500,000			$500,000
Machinery and equipment	200,000			200,000
U. S. Victory bonds	100,000			100,000
Merchandise inventory	125,000		125,000 I	
Cash	58,000			58,000
Accounts receivable	250,000			250,000
Notes receivable	100,000			100,000
Accrued interest receivable	4,500		2,000 C	
			2,500 E	
Administrative expense		50,000 H		50,000
Purchases (for inventory, Dec. 31)		125,000 I		
Purchases (for cost of sales)		125,000 J		250,000
Selling expense		25,000 K		25,000
	$1,337,500			$1,533,000
CREDITS				
Capital stock	$300,000			$300,000
Notes payable	350,000			350,000
Accounts payable	158,000			158,000
Interest accrued payable	3,000	3,000 A		
Surplus	314,000	64,000 L		250,000
Reserve depreciation, land and buildings	120,000	20,000 B		100,000
Reserve depreciation, machinery and equipment	80,000	30,000 D		50,000
Reserve, doubtful accounts	12,500	12,500 F		
Profit and loss (accrued interest)			3,000 A	
Profit and loss (depreciation, buildings)			20,000 B	
Profit and loss (interest on notes received)		2,000 C		
Profit and loss (depreciation, mach'y and equip't.			30,000 B	
Profit and loss (interest on Victory bonds)		2,500 E		

Debits	Balance-sheet	Closing entries reversed		Trial balance before closing
Profit and loss (doubtful accounts)			12,500 F	
Profit and loss (sales)		325,000 G		
Profit and loss (administration expense)			50,000 H	
Profit and loss (cost of sales)			125,000 J	
Profit and loss (selling expense)			25,000 K	
Profit and loss (net profits)			64,000 L	
Sales			325,000 G	$325,000
	$1,337,500	784,000	784,000	$1,533,000

Question No. 3:

An abstract of the cash account of the collector and treasurer of the borough of Eloka is presented to you, showing the following figures:

Receipts:		
On hand beginning of year	$ 2,000.00	
(General account $1,500.00, special account being from assessments, $500.)		
Taxpayers, on account of taxes	47,000.00	
Assessments for improvements	1,000.00	
Licences, fees and permits	1,800.00	
Interest	300.00	
Emergency notes (to meet cost of repairing bridge wrecked by storm)	3,000.00	
Payments:		
Accounts payable (previous year)		$ 1,300.00
Salaries		5,300.00
Police department		19,000.00
Fire department		12,000.00
Street lighting		800.00
Interest on funded debt		2,250.00
Bonds retired		10,000.00
Repairs to bridge		2,800.00
Balance on hand end of year		1,650.00
	$55,100.00	$55,100.00

A copy of the budget adopted at the beginning of the year is as follows:

Estimated revenue (licenses, fees, etc., $1,500; interest, $200)	$ 1,700.00
Amount certified to be taxed	48,200.00
	$49,900.00

Appropriations:

Salaries	$ 5,000.00
Police department	19,500.00
Fire department	12,000.00
Street lighting	900.00
Interest on funded debt	2,500.00
Bonds retired	10,000.00
	$49,900.00

The taxes assessed were, however, $49,700, instead of $48,200, but allowances were made amounting to $800, which reduced the amount actually collectible to $48,900. At the end of the year the following unpaid bills were on file:

Police department	$300.00
Fire department	50.00

At the beginning of the year there were uncollected taxes from previous years of $2,800, on the one hand, and unpaid bills $1,300, on the other hand, which, with the cash on hand, showed an apparent balance on general or current account of $3,000. At the same date the funded debt was $50,000, and unpaid assessments for improvements were $1,400, showing with the cash on hand on surplus account a net debt (excluding general account) of $48,100.

Prepare a balance-sheet at the close of the year (dividing it into its two main sections of current and capital accounts, respectively) and also a statement showing the operations for the year. State also what is the net debt of the borough at the close of the year.

Answer to Question No. 3:

To find the balance-sheet figures at the close of the year it is necessary to have—

1—Balance-sheet of beginning of year:

(a) Current fund balance-sheet.

(b) Capital fund balance-sheet.

2—Record of the budget adopted at the beginning of the year.

3—Record of all financial transactions throughout the year.

All items under 1, 2 and 3 must be carried into the proper general ledger accounts. Since, in this problem, the items covered are so few in number, each account may be dealt with individually in the general ledger. When there is a number of accounts under each class of revenue and expenditure, such detail accounts may be carried in a subsidiary ledger, and each group of detail accounts may be controlled by a specific account in the general ledger.

The following are the balance-sheets of the beginning of the year:

Current Fund Balance-sheet

Assets		*Liabilities*		
Cash	$1,500	Accounts payable		$1,300
Accounts receivable:		Current surplus:		
Taxes (classification not indicated)	2,800	Cash in excess of current liabilities	$ 200	
		Accounts receivable	2,800	3,000
	$4,300			$4,300

Capital Fund Balance-sheet

Assets		*Liabilities*		
Cash	$ 500	Bonds (classification not indicated)		$50,000
Assessments receivable	1,400	Capital surplus:		
Property and improvements	50,000	Cash	$ 500	
		Accounts receivable	1,400	1,900
	$51,900			$51,900

Having the balance-sheets of the beginning of the year, the next step is the making of proper opening journal entries. These are as follows:

Estimated revenues		$1,700	
Licence fees	$1,500		
Interest	200		
Taxes receivable (amount certified to be taxed)		48,200	
Budget appropriations			$49,900

To bring upon the books a record of the amount of budget appropriations to be met by taxes and current revenues, the appropriations are classified as follows:

Salaries	$5,000
Police department	19,500
Fire department	12,000
Street lighting	900
Interest on funded debt	2,500
Bonds to be retired	10,000
	$49,900

Journal entries—to cover additional taxes as assessed and allowances made thereon:

Taxes receivable	$1,500	
Taxes not anticipated in budget		$1,500
Taxes not anticipated in budget	800	
Taxes receivable		800

To record allowances.

The cash receipts and payments for convenience are set up as journal entries. Cash receipts are:

Current fund cash....................	$52,100	
Taxes receivable		$47,000
Licences, fees and permits...........		1,800
Interest		300
Emergency notes		*3,000
To meet cost of repairing bridge wrecked by storm.		
Capital fund cash....................	$1,000	
Assessments receivable..............		$1,000

Cash payments are:

Accounts payable	1,300	
Salaries	5,300	
Police department	19,000	
Fire department	12,000	
Street lighting	800	
Interest on funded debt.............	2,250	
Bridge repairing	2,800	
Current fund cash..................		$43,450
Bonds	10,000	
Capital fund cash..................		10,000
Capital fund cash....................	10,000	
Current fund cash..................		10,000

Transfer of revenue from current funds to capital fund cash used for retirement of bonds.

Skeleton Ledger Accounts

Current Fund Accounts

Cash

1st of year balance......	$ 1,500.00	Sundry payments........	$43,450.00
Sundry receipts..........	52,100.00	Capital fund cash........	10,000.00
		Balance	150.00
	$53,600.00		$53,600.00

Accounts Payable

Cash payment...........	$1,300.00	Balance	$1,300.00

* From *Municipal Accounting*, Eggleston.
Classification of funds:
1—Current fund
(a) Appropriation
(b) Special revenue bond funds
(b) =Resources derived from the sale of special revenue bonds which are issued in anticipation of tax levies (provision for their redemption being included in the tax levy following the year of the issue) and are subject to special revenue bond fund authorizations.

Licence Fees

Estimated revenue.......	$1,500.00	Cash received............	$1,800.00

Interest

Estimated	$200.00	Cash received...........	$300.00

Emergency Notes

		To meet cost of repairs to bridge	$3,000.000

Bridge Repairing

Payments	$2,800.00		

Taxes Receivable

1st of year balance.......	$2,800.00	Allowances	$ 800.00
Estimated (budget)......	48,200.00	Cash received...........	47,000.00
(Not anticipated)......	1,500.00	Balance	4,700.00
	$52,500.00		$52,500.00

Current Surplus

		Balance	$3,000.00

Budget Appropriations

			$49,900.00

Taxes Not Anticipated in Budget

Allowance	$ 800.00		$1,500.00

Salaries

Cash payment............	$ 5,300.00	(budget $5,000)	

Police Department

Cash payments.......... (budget $19,500)	$19,000.00	Accounts payable..........	300.00

Fire Department

Cash payments..........	$12,000.00	(budget $12,000)	
Accounts payable..........	50.00		

Street Lighting

Cash payments...........	$ 800.00	(budget $900)	

Interest on Funded Debt

Cash payments...........	$2,250.00	(budget $2,500)	

Skeleton Ledger Accounts

Capital Fund Accounts

Cash

Balance 1st of year.......	$ 500.00	Bonds	$10,000.00
Assessment received......	1,000.00	Balance	1,500.00
Transfer from current fund	10,000.00		
	$11,500.00		$11,500.00

Property

	$50,000.00		

Assessments Receivable

Balance 1st of year	$ 1,400.00	Cash received	$ 1,000.00
		Balance	400.00
	$1,400.00		$1,400.00

Bonds

Cash payments	$10,000.00		$50,000.00
Balance	40,000.00		
	$50,000.00		$50,000.00

Capital Surplus

		1st of year	$ 1,900.00

STATEMENT OF OPERATIONS FOR YEAR

Current Fund

Receipts

			—Affecting end of year surplus—	
		Budget	*Addition*	*Deduction*
Licence fees	$1,800.00	$1,500.00	$300.00	
Interest	300.00	200.00	100.00	
Taxes	48,900.00	48,200.00	700.00	
Emergency notes	3,000.00		3,000.00	
	$54,000.00	$49,900.00	$4,100.00	

Payments

		Budget		
Salaries	$ 5,300.00	$ 5,000.00		$300.00
Police department	19,300.00	19,500.00	$200.00	
Fire department	12,050.00	12,000.00		50.00
Street lighting	800.00	900.00	100.00	
Int. on funded debt ...	2,250.00	2,500.00	250.00	
	$39,700.00	$39,900.00	$4,650.00	$350.00
Emergency bridge repairing	2,800.00			2,800.00
			$4,650.00	$3,150.00
Deduct deductions from additions			3,150.00	
Net additions to current surplus			1,500.00	
Current surplus, beginning of year			3,000.00	
Total current surplus, end of year			$4,500.00	

THE CAPITAL FUND ACCOUNT

The capital fund account shows receipts of $1,000.00, representing collections on account of assessments receivable at the beginning of the year, plus $10,000.00, as appropriated for retirement of bonds.

There is nothing in the problem to indicate that there is property worth $50,000.00 as a result of the original issue of bonds. If, however, that is the case, the difference between the property value and the funded debt ($40,000) would constitute a surplus, in addition to cash and assessments receivable.

The two balance-sheets are herewith presented:

CURRENT FUND BALANCE-SHEET
Close of Year

Assets

Cash	$ 150.00
Taxes receivable	4,700.00
	$4,850.00

Liabilities

Accounts payable			$ 350.00
Surplus:			
Appropriated:			
Interest	$250.00		
Street lighting	100.00	$ 350.00	
Emergency bridge repairs		200.00	
Accounts receivable in excess of accounts payable		3,950.00	4,500.00
			$4,850.00

CAPITAL FUND BALANCE-SHEET
Close of Year

Assets			*Liabilities*		
Cash	$1,500.00		Bonds		$40,000.00
Assess. received	400.00	$1,900.00	*Excess of assets over liabilities:*		
			Cash in excess of current liabilities	$1,500.00	
Property & improvements (as per balance-sheet at beginning)		50,000.00	Accts receivable	400.00	
				$1,900.00	
			Property value in excess of bonded debt	10,000.00	11,900.00
		$51,900.00			$51,900.00

Question No. 4:

Explain the distinction between real reserves and nominal reserves. Give two examples of each.

Answer to Question No. 4:

Sir Arthur Lowes Dickinson uses the terms "voluntary" and "necessary." He says, "In considering reserves it is important to distinguish between voluntary reserves and necessary reserves; the former being mere allocations of surplus, while the latter are either an actual liability or a deduction from the book value of an asset."

This distinction is frequently entirely ignored, both classes of reserves being lumped together, usually as liabilities, but sometimes as divisions of the surplus.

A real or necessary reserve is one which represents an actual diminution in value that has already taken place or is inevitable from the nature of things in the future. Its proper function should be limited to those losses the exact amount of which cannot be determined but must be estimated. If the amount of the diminution is known it is better to write down the asset than to set up a reserve against it. For instance, if one-seventeenth of the cost of a patent is being written off each year it is better to credit patent account direct.

Examples of this class of reserve are reserve for depreciation of machinery and reserve for bad and doubtful accounts.

The other class of reserves, the nominal or voluntary, are those which represent losses or diminutions of value which may possibly occur but are not inevitable. In this case the reserve does not represent an actual loss, but is set up as a sort of warning to the stockholders that they may expect a disaster of some kind in the future. There being no certainty, perhaps hardly a probability, of any such catastrophe, the reserve is manifestly not an existing liability nor a diminution in value. Its function is the protection from more or less remote contingencies. As this is also the function of the surplus itself, these nominal reserves should always be included with the surplus to show the total of the surplus undivided profits at the date of the balance-sheet. The real reserves should be shown either as liabilities or as deductions from their appropriate assets.

Examples of nominal reserves are reserve for storm damage in an electrical company with overhead wires and reserve for accidents.

Under nominal reserves may also be classed appropriations of surplus in fulfilment of contracts with creditors, such as a reserve for sinking fund, or in accordance with the action of stockholders or directors, such as a reserve for plant extension.

Question No. 5:

In the course of a balance-sheet audit of a large corporation, why should the examination of repairs charged to cost of operations receive special consideration in relation to the liability for federal taxes?

Answer to Question No. 5:

The auditor should always pay special attention to the repairs charged

to cost of operation. If any of these represent real additions to the value of the plant they should be charged to plant account; otherwise costs are overcharged and profits diminished below what they should be. As far as the company itself is concerned this makes a difference in the book value of fixed assets and in the earning capacity.

This may not be very important, but, when the question of the profits taxable by the federal government is brought in, any diminution of the profits that is not really justified may entail serious consequences in penalties and fines. The auditor should therefore be careful not to pass any repairs as cost of operation that may possibly be considered as actual betterments.

The proper treatment of repairs affects not only the taxable profits but also the invested capital, which is an element in computing the tax liability.

Question No. 6:

In the case of a company which publishes an annual balance-sheet but no profit and loss account, state whether or not you would recommend to your client that the profits earned during the year, less dividends paid, be shown on the face of the balance-sheet. Give your reasons.

Answer to Question No. 6:

The stockholders of a corporation should be given complete and satisfactory information with regard to its financial condition and its earning capacity. For this reason the publication of the annual balance-sheet is far from being sufficient. There should also be a more or less detailed revenue statement. If the officers and directors do not wish to publish this detailed statement the next best thing to do is to include in the balance-sheet, under the heading of surplus, an explanation of the change in the balance of that account between the beginning and the ending of the year.

This explanation must be so classified as to show the results of normal activities and of accidental profits and losses, if there are any. That is, the surplus item in the balance-sheet should begin with the balance, January 1, entered short. To this are added the net operating profits, then any extraordinary profits, and from this total are deducted any extraordinary losses. From the remainder are deducted any dividends that have been declared, and the result is carried out as the new balance of surplus.

This is not at all satisfactory, but it at least prevents the inclusion of extraordinary or accidental profits from the results of operation, which might be made the means of deceiving stockholders into thinking that the earning capacity was greater than it is.

Question No. 7:

Can surplus be created in any way other than through profits earned from operations? Explain.

Answer to Question No. 7:

Before this question can be answered with certainty, accountants will have to agree on a definition of *surplus,* a word which, as used by some accountants, has a very inclusive meaning and, as used by others, has a much more restricted meaning.

Mr. Kester defines the word thus: "Under the corporate form of organization, 'surplus' in its broadest sense represents the difference between the

net worth of the business and the capital stock issued and outstanding." Accepting this definition, any transaction which results in a realized increase in the difference or margin between the net worth and the outstanding stock would result in an increase in the surplus. These transactions may be grouped into two classes.

(1) Transactions which increase the net worth or net assets without correspondingly increasing the outstanding stock.

(a) Operating profits form the usual source of such increases.

(b) Extraneous or capital profits arising from the sale of investments or fixed assets and other transactions outside the scope of the regular operations also increase the surplus, thus defined, provided they result in a realized increment. The mere writing up of an asset to market value does not result in a realized increment, and should not be allowed to affect the surplus.

(c) The sale of stock at a premium increases the net assets more than it increases the outstanding stock, and the difference may be added to surplus.

(d) Donations of cash or other assets made by stockholders to the corporation also result in an increase of the surplus. Corporations sometimes receive from outsiders donations of factory sites or other assets, and these may be put on the books by offsetting credits to surplus.

(2) Transactions which decrease the outstanding stock without correspondingly decreasing the net assets.

(a) Stock may be donated to the company by stockholders to get rid of a deficit or to be resold to provide working capital, and such donations may be credited to surplus.

(b) Similarly, in reorganizations, the old stock may be called in and a smaller amount issued, the difference being absorbed in the surplus account.

(c) If a corporation buys its own stock and pays less than par for it, the outstanding stock is decreased more than the net assets are decreased. The difference may be credited to surplus, but if the stock is held in the treasury for resale it would be conservative to carry the difference in a contingent profit account until the profit is realized by a reissue.

It must be remembered that the propriety of crediting these items to surplus depends entirely upon whether this inclusive definition of surplus is acceptable or not.

Mr. Kester, after stating the definition quoted above, goes on to say that "the highest accounting authorities are coming to restrict surplus to that portion of the margin available for dividends." Mr. Montgomery's definition concurs with this: "The 'surplus' of a corporation should represent an actual surplus; that is, a balance of net profits after all reserves have been provided, including the reserves *out of* surplus, such as working capital, etc., leaving an amount safely distributable as dividends."

If this restrictive definition is accepted, the effect upon the entries for the transactions enumerated above may be shown by further quotations from Mr. Montgomery, arranged in accordance with the preceding classification.

(1-a) Operating profits. These would be available for dividends, subject to any reductions caused by the appropriations of surplus for other purposes, such as appropriations to a reserve for working capital. Mr. Montgomery says:

"It has been held to be legal to set aside annually or at other periods out of the earnings of a company a reasonable amount as a reserve for additional working capital, which is therefore not distributable in the shape of dividends. This reserve may be temporary or permanent, as the directors may determine, and corresponds with the surplus of a bank or trust company, which is never used for the purpose of dividends unless some extraordinary occasion arises. The account is a discretionary one and is almost entirely a matter of bookkeeping, or rather it is a sort of notice to stockholders that the amounts so set aside will not be distributed.

"To treat such an account as a liability is a fallacy, because at any time the directors can transfer the entire balance to general surplus and pay out all or any part of it in dividends. Therefore the account should always appear on the balance-sheet as a section of surplus, and never among the liabilities."

(1-b) As to extraneous or capital profits, Mr. Montgomery, under the caption *Profit on Sale of Assets,* says:

"It may be that a profit has been realized on the sale of a portion of the fixed assets of a concern. Legally this profit may be carried to surplus and distributed as a dividend, but such a course is apt to create a false impression on stockholders. It is much better to carry such an item to an account whose caption indicates the character of the entries therein, and which may be carried on a balance-sheet as a separate section of the surplus account. Under such circumstances it will not appear to be applicable to dividend distribution, and can be held as a contingent reserve against possible losses on other capital adjustments."

(1-c) Relative to premiums or sales of stock, Mr. Montgomery expresses the following opinion: "Where stock has been sold at a premium, the auditor will see that all premiums have been collected. The funds so realized should be credited to premiums on capital stock account, which should remain open, and appear on the balance-sheet as a special surplus account. In no event, however, should the account be transferred to general surplus and thus be looked upon as available for dividends. It would probably be legal to declare a dividend out of funds so raised, but it would be so improper as to sustain a charge of dishonesty against the director who voted therefor."

(1-d) The quotation under (2 a, b, c) relative to donations of stock would seem to apply equally to donations of assets.

(2 a, b, c) Donations of stock should not affect the surplus account, according to the following quotations from Mr. Montgomery: "If purchased by the corporation, cost price is the correct basis of book entry; if acquired by gift, opinions differ as to the form of entry. The best authorities sanction the setting up of the stock as an asset at par value, offsetting this entry by the creation of a reserve or surplus account which is designated as a

capital item, and is clearly differentiated from the surplus which arises out of profits or which is available for divdends."

It will be seen that the entries to surplus account depend wholly on the definition of surplus. Mr. Walton died before the copy for this issue was completed and he did not see this answer, but the following expression of his opinion shows that he favored the more inclusive definition:

"In a partnership, surplus profits are credited to the capital accounts of the partners. These capital accounts can vary at the will of the partners. In a corporation the capital stock is fixed by the charter. When the net worth of the business exceeds the capital stock the excess is surplus capital and must be credited to surplus account.

"It does not make any difference how the excess profits arose. If the profits are real they belong to the surplus account—if they are not real they do not belong on the books at all.

"The various sources from which surplus is derived may be designated by a subdivision of the account, but on the balance-sheet these subdivisions must be assembled in one total to the credit of surplus account so as to show the accumulated undivided profits of the business to date."

Montana Society of Certified Public Accountants

At the annual meeting of the Montana Society of Certified Public Accountants, held June 12th at Helena, the following officers were elected for the ensuing year: President, Ernest E. Murray; vice-president, W. Grant Hoage; secretary, W. A. Logan.

Utah Association of Certified Accountants

The Utah Association of Certified Accountants was organized at a meeting July 8, 1920. Constitution and by-laws were adopted and the following officers were elected: president, R. G. Abbey; vice-president, Lincoln G. Kelly; secretary and treasurer, B. F. Reeves.

Haskins & Sells and H. S. Champlin announce the consolidation of their practices, to be conducted under the name of Haskins & Sells, and under the management in Buffalo of Mr. Champlin. The offices are in the Marine Trust Company building.

Otho G. Cartwright, member of the American Institute of Accountants, announces the removal of his offices to temporary quarters at 45 Cedar street, New York.

Patterson, Teele & Dennis announce that Edward H. Moeran and David Leslie Milne have been admitted as partners in the firm.

The Journal of Accountancy

Official Organ of the American Institute of Accountants

Vol. 30 SEPTEMBER, 1920 No. 3

Certified Financial Statements as a Basis for Credit*

By John Raymond Wildman

The way from hiding shell money in the crevices of rocks to the gigantic and versatile financial institutions of to-day is a long one. The sole idea in the former situation was to preserve the funds and protect them against loss. The modern financial institution maintains the same idea but at the same time makes the funds available for use.

The old idea that a bank was a place in which to keep money has given way to a new order of things wherein the bank has become an institution in which to accumulate funds in order that they may be made available for the financial needs of the country.

The country owes much to the banker. He has been an important factor in the expansion and development of business. He has become an instrument of service in financial matters, locally, nationally and internationally. He gives advice as to investments, taxes, general business procedure and sometimes matters of accounting. He does all this freely and the service is gratuitous.

The banker makes most of his money through the lending at interest of funds which have been deposited with him and for the use of which he suffers, generally speaking, only the expense of keeping the depositors' accounts.

But the banker has certain duties and responsibilities. To his depositors he is liable for maintaining intact the loanable fund constituted largely by their deposits. To the stockholders he is responsible for the integrity of their capital. To the public he may be regarded as having the moral obligation of acting as controller and regulator of industry and business.

Good judgment is necessary if the loanable fund is not to be

*A paper read before the Utah Bankers' Association at Ogden, June 19, 1920.

impaired through losses. Courage, vision and public-spirited interest are necessary if the banker elects to play his part in regulating financial affairs as opportunities offer.

Some few years ago a previously unknown individual, under the cloak of corporate organization, opened a new department store in New York. The show windows contained goods which were cheap looking and tawdry. The advertising copy was undignified and unconvincing. Everything about the store contributed to an atmosphere which was anything but first class. The establishment continued only a few months. The company failed. The failure disclosed the fact that three prominent New York banks were creditors in the amount of about three hundred and sixty-five thousand dollars, no part of the loans being secured. Fortunately, the resources of these banks were adequate to permit of writing off the losses scarcely without impression on the operating results. But the thing at which one must marvel is that three big banks should fall victim to the guile of so crude a representative of the merchant class. These banks along with the other creditors took a liquidation dividend of about ten per cent in settlement.

Within the past three months a well-known building in the financial district of New York was sold to real estate speculators for $2,500,000. Tenants were immediately notified that rentals would be increased as soon as leases should expire. Space on the first floor might be had, it was announced, at fifteen dollars a square foot; that on the second and third floors at ten dollars; that on floors above at six. The average cost to tenants under old leases averaged between two and three dollars a square foot.

In keeping with their philanthropic policy the real estate operators decided to offer to the tenants of the building the first opportunity to purchase it. The asking price was $5,000,000. At last report it had been reduced to $3,500,000. There is little prospect that the tenants will purchase the building. There is not much doubt that someone will purchase it and in the not-far-distant future.

The banks are furnishing the money for speculation in real estate, unconsciously perhaps, but none the less truly, just as they are supplying the money for speculation in other lines. To remedy

the situation the first thing is to realize that it exists. To find the remedy is another matter.

Raising the discount rate will not stop speculation. The real-estate trader who is able to make from one hundred to one hundred and twenty-five per cent per annum on money, cares little for an increase of one or two per cent in the discount rate. Discrimination in the matter of loans would apparently accomplish much more. Loans only for sound, conservative, up-building business purposes would do much to stabilize conditions and bring down the general price level.

The reputed basis for business loans is confidence. The late J. Pierpont Morgan has been credited with the fantastic statement substantially to the effect that he would rather lend a million dollars without security to a man in whom he had confidence than a thousand dollars on the best security in the world to a man in whom he had no confidence.

Confidence is the belief on the part of the lender that the borrower will be willing and able to repay. The belief may be founded on past experience, on the known business standing and reputation of the borrower or on the result of investigation of his character and integrity. But when he fails to pay at the appointed time the confidence availeth nothing. Many a borrower has taken the money in the best of faith. Many a borrower has been willing to pay at maturity without being able so to do.

Some banks lend altogether on confidence. Others ask prospective borrowers to furnish financial statements. There are borrowers who submit statements which are wrong and misleading because of ignorance on the part of those who prepared them. There are others who offer financial exhibits which are intended to deceive.

An applicant for a loan at one of the large trust companies recently submitted a balance-sheet which deliberately overstated the assets and understated the liabilities. The cash shown as on hand took no cognizance of the cheques outstanding. The customers' accounts were all said to be good, yet investigation developed the fact that scarcely one per cent was really collectible. The inventory, stated to be worth $45,000, was found to be worth, on the basis of a liberal appraisal, about $12,000. Liabilities said to be entirely in favor of trade creditors included amounts borrowed

from a bank. No mention was made of amounts which had been borrowed from relatives.

The trust company in question refused the loan because the applicant refused to submit a certified statement. The above facts were developed subsequently when in bankruptcy proceedings the attorneys for the bankrupt offered a composition of something like two cents on the dollar and an investigation was made at the instance of certain creditors in an effort to determine the true situation.

The banker is not charged with the duty of being an accountant, but he is scarcely to be classed as a banker these days if he is not able to read and interpret a balance-sheet. It should be said in their praise that bankers are as a rule very adept at this sort of thing. But again it is a matter of confidence—the acceptance of the facts as stated—the belief that reliance may be placed upon the representation of the statement.

The unsupported financial statement of the applicant for a loan is better than no statement at all, but it does not answer the purpose. First, because it frequently leaves something to be desired in the matter of presentation; second, because it offers no other basis than confidence.

The financial facts represented by the statement should be verified. It is not sufficient that the assertion of the applicant be accepted if the banker would avail himself of every opportunity to safeguard the funds of the bank. Many a plausible story, supported by what has appeared to be good evidence, has carried sufficient persuasion with it to extract money from the cashier of a bank where an armed force could not have done so.

The borrower is naturally biased in his own favor. Without of necessity misrepresenting anything or in any way misleading he is always optimistic as to his financial condition and presents his case in the most favorable light. The independent and disinterested investigator has no such bias. He searches out the cold facts. He presents them in equally cold-blooded manner. Further, he certifies to them.

Some few years ago the American Association of Public Accountants, now the American Institute of Accountants, addressed an inquiry to the bankers throughout the country asking them to express their attitude toward certified financial statements as a

basis for credit. Eight hundred and forty-four replies were received and classified as follows:

Strongly in favor	121
Favorable	501
Opposed	15
Strongly opposed	5
Non-committal	202

Among those in the first class were some of the foremost bankers in the country. Those opposed or strongly opposed obviously failed to catch the significance of the inquiry or had experienced difficulty in obtaining through accountants' certificates the measure of protection which they demanded. The non-committal group was comprised largely of banks in small places where the personal acquaintance of the bank officers with the borrowers and their affairs made it unnecessary to require certified statements. As many expressed it, "The idea is all right, but it doesn't apply in our case."

One banker in Omaha, Nebraska, cited an instance where his bank had been saved $40,000 through having insisted on a certified statement which the borrower declined to furnish. Another bank made the loan and subsequently took the loss.

A St. Louis bank officer replied as follows: "During this year we have found that three of our borrowers falsified their statements. The net loss to us was about $20,000. Certified statements would have saved us that sum."

From Pawtucket, Rhode Island, comes the following statement: "We give preference in buying brokers' paper to statements certified by public accountants well and favorably known to us."

Statements prepared to be submitted to bankers should be so fashioned as to supply quickly, fully and succinctly the information which the banker needs in coming to a conclusion as to the present status of affairs and prospects for the future. An accountant will only succeed in this respect as he is able to put himself in the place of the banker who reads the statement. A balance-sheet prepared for stockholders or prospective investors might contain all the information which the banker needs, but presumably would not be as satisfactory as one which would focus the attention immediately upon the liquid aspect of the situation.

The lending banker is concerned chiefly with his position in case

he makes the loan and with the probability of repayment. It is essential to good banking practice that the loanable fund be not tied up in long-term loans. The banker is anxious, first, that he shall get back the funds which he has lent, and, second, that he shall get them back within a short time. Thus is the loanable fund kept in circulation.

Having this in mind the banker generally looks immediately at the liquid assets. He compares them quickly with the current liabilities. He is likely to be interested in the ratio which the net liquid assets bear to the total liquid assets, representing the margin of safety, as it were. Like the credit man he is always more impressed if the liquid assets are at least twice the current liabilities.

One by one he goes over the liquid assets, regarding them always in the light of the rapidity with which they may be converted into cash. Current liabilities will be examined with regard to the order in which they take preference and the pressure which they exert as to payment. All these inquiries the banker directs at the statement with the idea of trying to determine what will be the outcome in so far as he is concerned, if he decides to take the place temporarily of some of the present creditors or furnish additional working capital to the enterprise for a time.

The statement to be satisfactory must exhibit the financial vigor of the business, must show what it has been doing in this respect in the recent past and give some indication of the prospects for the future. For such purposes a comparative statement of financial condition is desirable. It should, however, be supplemented with a statement showing the net sales for the last year. Thus is the reader of the statement apprised of the conditions under which he enters into the relation of creditor.

As one banker has said, "A balance-sheet will not validate an inventory." It might be added, "no more will it validate any other item thereon." Without certification it is essentially a document which must be taken on faith, and, at that, faith in an interested party.

The certified balance-sheet does validate the inventories as well as all the other items. It means, as to inventories, for example, that the accountant has satisfied himself that they represent sound values; that they contain no obsolete or unsalable material; that they have been priced at cost or market, whichever is lower, unless

otherwise stated; and that, generally speaking, the value placed on the inventories is one which they may reasonably be expected to realize in case of necessity.

In the present peculiar economic condition, in which this country now is found, the banker is brought into a position of more than usual importance. First, because the general increase in the price level, having brought about a condition in which twice as much working capital as formerly is required, has sent an increasing number of borrowers, who are not in a position to re-finance through capital obligations, to the banks for current loans. According to statistics which appeared recently, commercial loans increased from January 1 to April 30, 1920, one billion, one hundred millions of dollars ($1,100,000,000) or 10 per cent. Incidentally, during the same period Wall street loans decreased 7 per cent.

Secondly, the banker's position is important because during the movement which has as its purpose enforced deflation, the honest commercial borrower will suffer most. Being forced to sell at low prices goods into which have entered high priced material and labor, the manufacturers and merchants are likely to find themselves embarrassed to meet current obligations and forced to turn to the banks quite legitimately for assistance.

In the third place, the banker plays an increasingly important role because of the demands upon him for funds with which to take advantage of present-day financial opportunities. With the present condition of the stock market, nothing is so cheap as securities. There are huge profits to be made in real estate. The manufacture of sweets, to take the place of alcohol, and foreign trade ventures give most tempting promise of large returns. The conservative banker who has the good of the country at heart and who wishes to be a factor in settling conditions and bringing down prices so that they will stay down frowns on applications for loans of this character. Nothing will contribute more to the lowering of prices, it is believed, than discrimination by bankers, including officers of the federal reserve banks, in the making of loans.

In all these cases the banker needs facts from which to proceed. It is contended that certified financial statements prepared by

duly qualified independent accountants may be a most effective means of assistance to him in these matters. They may be of help to him in exercising judgment as to the granting of loans. They may help to satisfy him subsequently as to the judicious use of the funds so lent. They will help him in keeping the loanable funds of the country employed to best advantage while taking every precaution as to their safety and prompt return.

How to Write a Report*

By Walter A. Staub

Too much emphasis cannot be placed on the importance of a well-written, informing report to a client upon completion of an engagement, or even before its completion if the circumstances are such as to call for a preliminary report.

The report is the means by which the accountant maintains his line of communications with the client. In many cases the client himself may see little of the members of the staff directly engaged on the work, and his impression of the value of the work done will be based in a large measure on the report submitted. The remarks which follow are suggestions inspired by observation of the fate of many report drafts, the impressions gained of their virtues or faults, and the conviction that there are certain aims to be held in view and pitfalls to be avoided in writing a report.

Don't be stereotyped. Some men seem to labor under the impression that it is necessary to prepare the text of reports in the same form which they have found used by other men when first joining the staff. This stereotyped form most often consists of comments *ad seriatim* on the items of the balance-sheet; and before beginning to read the report one already knows it will read something like this:

> We have checked the bank balances and counted the cash on hand; we have verified the trial balance of accounts receivable ledger, etc., etc.,

going through all the minutiae of insurance and other prepaid expenses (often of comparatively small amount), through the liabilities one by one, and then to the capital stock.

At this point, if the matter is referred to at all, the operations of the year, which usually are or would be of greater interest to the client than most other features of the report—particularly if it is a periodical audit—are dismissed with a word or two of trite comment or of reference to the appended earnings and expense statement.

* Summary of an address to members of the staff of Lybrand, Ross Bros. & Montgomery.

This is a quick way to write a report, but it doesn't make an interesting or valuable one. For instance, we have clients for whom we have been making annual audits for the past ten, fifteen or twenty years, and you can imagine with what eagerness they await and with what mental stimulation they read each year the report that brings them the astounding news that once again we have verified the bank balances and counted the petty cash and actually found them to be correct! If a client had a suspicion that such an obvious thing as verifying the cash balance were not being done he would probably soon change auditors. Some things are so obviously a part of the auditor's duty that in the absence of a definite statement to the contrary it is to be assumed that they have been done.

To sum up under this head, let us get away from this stereotyped form of balance-sheet comment and use it only when it is really demanded. Cases in which this form of comment may appropriately be used will be referred to later.

Discuss important matters early in report. Ordinarily, try to put in the early part of your report really important matters, things that are vital and interesting to the client and to which his attention should be promptly called.

When important matters are preceded by comments on numerous minor matters, particularly if they are dealt with in a technical way, the client may be exhausted by the time he gets to the important items and may pass them by, saying to himself, "I guess the rest of it is all right." Thus some special comment, perhaps connected with operations of the year, may not attract attention because it was not stated in the early part of the report.

Don't elaborate on trifles. If a slight difference between controlling accounts and subsidiary ledgers should occur or there should be an error of two cents in petty cash, it may be right to mention the fact, but the average client does not want to be burdened with such non-essential matters. If errors are indicative of carelessness, even though otherwise not vital, it is advisable to report them, commenting thereon in as few words as possible. This treatment will please the average client much more than if such minor matters are unduly stressed.

Do not pad the report merely to have it run into a considerable number of pages. A brief report containing worth-while com-

ments is preferable to copious comments which are really much ado about nothing.

Cover everything vital. It is annoying to a client to have a report come to him and then later receive a supplemental report on something that had been omitted from the report proper, especially if the client be a banking or investment house floating issues of securities which has in the meantime issued circulars based on the initial report.

There are, of course, some engagements in which supplemental reports are entirely in order. For example, in brokerage or bank examinations supplemental reports are frequently necessary for the purpose of bringing to the client's attention accounts or loans for which confirmations have not been received.

Endeavor to make report interesting. Try to learn of things during the examination which will interest the client. The form of presentation frequently decides whether or not the client's interest will be aroused. Increasing the use of charts to facilitate the comprehension of developments or tendencies in sales, costs, margins of profit, etc., is well worth considering.

Use clear, concise English. The language used in writing a report should be clear and concise and should avoid ambiguity. Especially, avoid long sentences. When an effort is made to cut down the sentences, making them short and crisp, there is more likelihood of a clear statement of facts than when a long sentence starts at the top of a page and extends over to the next. Do not begin too many sentences with participles or indirect forms of expression.

Cutting up the text into short paragraphs helps to make a report clear. Theoretically, a new paragraph should be started only when a new train of thought begins, but strict adherence to this academic rule often results in discouragingly long paragraphs. Subdivision of an extended comment into a number of paragraphs facilitates its digestion.

A liberal use of paragraph captions also tends to facilitate the client's reading, study and comprehension of a report.

Study your client before you write your report. Different clients like different kinds of reports. Some clients will not read a twenty-five page report for love or money, while others delight in going into the minutest details of the business. Try to form

some idea of the kind of report that will appeal to the client or his responsible representatives.

Write report promptly. Unless a report is promptly forwarded to the client it is not apt to excite his interest when it arrives, but rather to arouse a feeling of peevishness because of delayed presentation. It is important that the accountant in charge of the work in the field get his draft report into the office as soon as the work is finished, because, at best, the review, typing and comparing of the report in the office after the draft arrives there must take some time. It makes an excellent impression on the client if he receives the report soon after the completion of the work.

Write report in client's office. Two strong reasons are advanced for writing the report draft in the client's office, whenever it is feasible to do so—and it usually is—viz.,

1. Accessibility of records.
2. The client appreciates the time spent on work.

As to accessibility of the records, if the draft is written at our office, questions or points coming up, on which more information seems desirable, necessitate much telephoning (with the possibility of the information received in this way not always being accurate) or perhaps involve an additional trip to the client's office. Particularly in the case of out-of-town engagements is it annoying, when writing the report after returning to the office, to find that data are lacking, the need for which was not previously seen.

If the report is written in the client's office, the records are available for securing readily such supplemental information as the drafting of the report discloses to be necessary. Also, explanations which it may be desirable to secure from the client's staff are more likely to be satisfactory if received on the ground than when obtained over the telephone or by mail. The difficulty of securing satisfactory explanations at long range tends to result in the slighting in the report of perhaps important matters.

When a report takes long to prepare, the client does not appreciate the time required to assemble papers and write and rewrite the report. He simply knows that the accountant is gone and gives no credit for time spent elsewhere.

Accept proper responsibility. Some reports would lead one to believe that they were written for the protection of the ac-

countant and to serve as an alibi in case it later developed that all was not as it should be in the client's affairs.

When a client, whether for reasons best known to himself or for reasons expressed to us, does not want the accountant to follow what appeals to the latter as the best procedure in making the examination, the accountant should, of course, make mention of the restriction in the report. Also, if by instructions of the client an examination is limited in scope, the report should not fail to disclose this fact. When, however, a client does not impose any restrictions or limitations, it is not fair to him to make the report an erudite collection of *ifs* and *buts*.

Supplementing the foregoing, it may be stated that certain engagements are of a special nature and ordinarily warrant the reports describing at least briefly the steps taken to verify the assets and liabilities. Bank and brokerage audits come into this class, because there are usually at least some items which even in a fairly comprehensive examination it may not be practicable to verify as conclusively as the auditor would wish. For example, the deposit accounts in a bank examination are seldom verified as exhaustively as would be theoretically desirable, and it is important not only to have this understood by the client but also to make it a matter of record in the report.

It is so obvious that it need hardly be stated that a good report can be written only if it has been preceded by a good examination, that is, one which is thorough, intelligently conducted and directed toward ends which will be of the greatest service to the client. As a conclusion of this discussion, it may be in order to repeat the proverb: "First be sure you're right and then go ahead."

Accounting for a Professional Institute*

By Edwin E. Leffler

Institutes, made up of members of a profession, are, as a rule, organized to promote and benefit that profession and as such their activities are diversified. Some of these activities are educational; some assist in maintenance of high standards of ethics; others concern the establishment of a library and keeping the members in touch with all new literature appertaining to the profession.

Accounting for an institute of this nature has many phases. The revenue comes from the payment of dues, the subscription to a monthly journal or bulletin, the sales of advertising and so on. The expenditures must be distributed to various committees and appropriations. While these organizations are not as a rule run to create a large surplus, it is essential nevertheless that they employ modern methods in their accounting.

In this paper I will endeavor to point out some of the salient features of a system for such an institution, covering the matter only in a general way and in the following order: first, describing the principal books necessary; then a simple chart of accounts; following this by a description of the method for recording the various revenues and expenditures; the preparation of a budget; the treatment of accounts payable and some other matters of a more or less general character.

In describing the books I shall omit all reference to minute books, members' records and books of a like character, simply confining myself to the accounting books. The principal books essential to a system for an institute are cashbook, journal, dues and sales journal, general ledger, members' dues ledger, petty cash book and possibly a miscellaneous accounts receivable ledger.

No description of the cashbook and journal is necessary except to say that they should be columnar books and that the headings for the columns can be worked out readily for any different classification desired. The members' dues ledger can easily be designed to cover a period of ten years by having the pages

*A thesis presented at the May, 1920, examinations of the American Institute of Accountants.

printed on both sides and perforated on both ends so that they may be reversed in the binder. Five sets of columns may be printed on each side to take care of five years. The columns should be divided for dues charged and dues paid showing date and amount under each heading. A short sheet with the members' numbers (entered in numerical order), names and grades, as "fellow," "member," "associate," may be printed; and this will last for a number of periods, changing the long sheet with the columns as frequently as necessary.

The dues and sales journal should have columns for date, bill number, name, total charge and distributions, such as entrance fees, current dues, past dues, subscriptions, etc.

A comprehensive chart of accounts should be thought out and arranged with regard to the peculiar necessities of the institute in mind. The following chart is submitted merely to cover the matter in a general way and is not intended to be a finished product.

Assets: real estate—buildings—furniture and fixtures—library—investments—inventories (year-book, journal, membership buttons, etc.)—cash—accounts receivable (dues, subscriptions, advertisement, buttons and miscellaneous)—cash in fund for promotion of membership—blank bond of fund for library extension.

Liabilities: accounts payable—advance dues—entrance fees and dues advanced by applicants—reserve for depreciation of buildings—reserve for depreciation of furniture and fixtures—reserve for fund for promotion of membership—reserve for fund for library extension—surplus.

Revenue: current dues—past dues—student dues—entrance fees—subscriptions—sales of special articles—sales of buttons—advertising—interest on bank balances—interest on investments—miscellaneous revenue.

Expenditures: salaries—binding and mailing journal—stationery and printing—general expenses—express—postage—meetings—membership committee expenses—standards committee expenses—year-book expense—blank medal award—dues written off as uncollectible.

Many of these expense items must be distributed to show the amounts expended for each of the various committees, necessitating, for example, several salary accounts.

Revenues in most instances will be from similar sources in all organizations, as entrance fees, dues, student dues, subscriptions, advertising, interest, sales of buttons and so on.

One of the main difficulties in designing a system of this kind will be the method of accounting for yearly dues. In describing this method let us start from the point when an applicant is voted a member.

The first step when an applicant has been voted a member is to assign to this member a number. These numbers should be used consecutively, taking the next open number from the short sheet in the members' dues ledger. This number should serve to identify everything appertaining to the member. It should appear on his bill for dues, be used for filing purposes and so on. When a member is dropped or resigns, after a certain time has elapsed his number should be used for a new member.

On the first of the year, all dues should be extended into the dues charged column of the members' dues ledger and bills should be mailed for these dues. The columns should be footed and the totals carried to the dues and sales journal. This should be proved by multiplying the number of members by the yearly dues. Dues of members elected during the year are charged through the dues and sales journal and distributed to the various columns. These charges are then posted to the members' dues ledger according to the numbers that have been assigned to them. Advertising, subscriptions, sales of buttons, etc., are charged through the dues and sales journal, distributed in appropriate columns and posted in the proper subsidiary ledgers.

Cash received is entered in the cash receipt book in proper columns. This entry should show member's account number in the case of dues, to facilitate posting to the members' dues ledger. Appropriate control accounts are set up in the general ledger and a proof of accounts receivable ledgers is taken at short intervals. At the end of the year, all dues unpaid are transferred by journal entry from current dues to past dues. Entrance fees, dues and any other money accompanying an applicant's application should be credited to a liability account, "dues and fees advanced by applicants." As members are elected their fees are

journalized from this account to entrance fees, dues and other appropriate accounts.

For purposes of following up delinquent members, after a definite period of time has elapsed and the members have not paid bills for dues, the membership mailing list may be run off on statement forms and arranged in numerical order. These may be readily compared with members' dues ledgers and statements for members in arrears may be sent out. After a certain time, notices should be sent out by the same method as above enclosing extracts from the by-laws relative to dues.

When bills are received they are verified as to the receipt of the goods and as to quantities. They are then checked as to prices and extensions. All these operations are indicated on the bills by means of a rubber stamp. Cheques are made out and distributed to the proper committees and appropriations. A statement of these disbursements is made, with sheets showing the amount charged to each appropriation for the period and the amount of the appropriation unexpended. These statements are submitted to the finance committee at its monthly meeting. When this statement of disbursements has been approved for payment by the finance committee and the chairman has signed the statement of cheques, the cheques and statement are delivered to the treasurer. The treasurer signs the cheques, verifying the amount of the cheques by the list approved by the finance committee. The cheques are then mailed, and the vouchers are stamped "approved for payment by the finance committee" with the date and numbers of cheques inserted in the proper spaces. The vouchers are then filed by vendors' names and each voucher has endorsed on it a complete record, thus showing that it has been completely checked and approved as well as showing the cheque number and date of payment.

An impress petty cash fund should be maintained for petty expenditures. Disbursements are made on a regular petty cash voucher properly approved by some designated person. These disbursements are distributed to the various committees' appropriations and a voucher showing such distribution is made out. This is submitted to the finance committee at the next meeting

and approved in the same manner as described in the previous discussion.

In a system such as is described here it probably will not be necessary to run a purchase journal and accounts payable ledger, but this liability should be reflected on the books at the time of the yearly closing. These bills cannot be distributed to the various committees, as they have not been approved by the finance committee. This liability may be shown, however, by setting up the bills unpaid at the close of the fiscal period as accounts payable and charging profit and loss by means of a journal entry. After the closing this entry should be reversed.

Towards the end of the fiscal year it is well to write to the chairmen of the various committees giving them all the detail possible as to the amount of the appropriations and expenditures for the previous years and asking for an estimate of their needs for the next year. When these estimates are returned a tentative budget is prepared for the consideration of the finance committee.

This tentative budget is submitted to the finance committee, with a statement in proper columns showing receipts in past years —from what sources the revenue was obtained—the disbursements in past years showing the amount expended for each committee—the amounts appropriated for each committee for the ensuing year—the estimated income from various sources for the ensuing appropriation year—the appropriations provided for the different committees for the preceding years—the estimated surplus or deficit for the ensuing year—the record of expenditures for different items of each committee's appropriation.

With these facts before it the finance committee prepares a final budget for the next year, showing the amount allotted to each committee and the purposes for which the appropriations are to be expended.

A monthly statement should be prepared and mailed to the chairmen of the various committees showing the expenditures of their individual committees to date, together with the amount of their appropriations still unexpended and any known expenses to be incurred for their committee.

Usually some revenue is received which is to be set aside for a specific purpose, such as a "fund for the promotion of technical papers." These funds may be carried as cash, preferably in a

savings bank or in investments in gilt-edged securities. These funds are best treated by setting them up as an asset and offsetting them by a reserve account for the same amount. Earnings or disbursements for the fund should not be reflected in the institute's earnings but should go direct to the fund for which intended. A statement of these funds should be incorporated in the annual report to the board of directors.

Some societies receive numerous donations. For these a receipt book printed and numbered consecutively should be used. For every donation received, a receipt should be forwarded to the donor, the stub or duplicate remaining as the society's record. These stubs should be footed once a month or at designated periods and the totals should be brought into the cash received book and be properly distributed.

Lists of donations should be published in the society's bulletin, and the people expected to donate to a certain society should be warned to see that they receive a receipt.

Careful account for membership buttons or badges sold to members should be made. Records should be kept of the amount of sales and the cost of these sales. This is important that the society may not lose money on sales, unless it is the policy to do so. On the other hand only a moderate profit should be made.

It is important that members' mailing lists be kept up to date. Forms should be prepared to record all changes of address, grade or other information. These forms should be initialed by the person making the change on the mailing list, ordering the new stencil or taking any other step that is necessary to complete the society's record of these changes.

It is good policy to have the books of the society audited regularly and the annual reports certified by a recognized firm of accountants.

In conclusion it may be stated that this article has only attempted to bring out some of the main features in a system for a professional institution and does not purport to cover the entire field. Much could be done in the way of standardizing accounts for institutes, as it seems to be a phase of accounting that readily lends itself to standardization. It would appear that a wide field is open for the accountant and that he owes it to his professional brother to give some thought to his brother's needs.

Iron Mine Accounting*

By Charles F. Bomer

In general the accounting of companies operating iron mines is similar to that in other lines of business, but there are several peculiarities in the system of keeping general accounts as well as in the cost accounts.

One of the most important features of the cost system is the charging off of the exhaustion of the mines through a reserve for depletion. This is important, because in mining an asset is being used up; and unless sufficient reserve has been set up during the time when the operations have been going on there will not be any capital left for the stockholders when the mine is exhausted.

Before operations begin, a survey of the mine is made and tests are made by engineers, from which they make an estimate of the number of tons of ore that are available for mining. This is done in various ways, usually by test borings at various places over the mine. The accounting side of this is taken care of by dividing the total cost of the land surveyed by the estimated number of tons of iron to be produced by the land. This gives a certain number of cents or fractions thereof per ton, which is the figure used to set up the reserve for depletion on each ton of ore mined. At the end of each month, a charge is made to cost of mining for depletion equal to the number of tons of ore mined during that month multiplied by the amount of depletion on each ton computed as above stated. The amount of depletion per ton is included on the cost sheet to show the cost of each ton of ore mined. The cost of the land is sometimes inflated by the promoters, but as the amount which the company pays is the cost of the property to the company, this is the amount that must be taken in calculating a per ton depletion amount.

This is true also of the shafts sunk and the shaft head constructed over the mouth of the mine. The shaft head is depreciated on the basis of all ore that will be reached by that shaft at every depth, while the cost of sinking the shaft is depreciated

*A thesis presented at the May, 1920, examinations of the American Institute of Accountants.

only by the amount of tons of ore to be mined from the levels to which the shaft is sunk.

Depreciation is handled in much the same way as in all lines of business except that the materials used have a very high rate of depreciation. The pumps used to pump the water from the mines, for instance, are depreciated at the rate of about thirty-three per cent annually. The equipment used under ground is also depreciated at a high rate, the electric locomotives being considered good for only four or five years.

The payrolls differ somewhat from those in manufacturing concerns, although they resemble somewhat the method of recording piece-work. The miners are employed on two different pay bases: one, the company contract, which is at a stated rate per diem; and another, the miner's contract, which is based on the amount of ore produced by him. On the company contract, the miner is paid a flat rate per diem and is supplied with all his tools and explosives free by the company. On the miner's contract, which is the more popular of the two, the men work in gangs, usually four men on the day shift and four on the night shift, and these gangs are assigned to mine a certain section of a runway. All the ore sent up by these eight men is credited to the crew or contract, and at the end of the month they are paid on the basis of eight equal shares of the money earned by their entire gang.

The ore is sent to the surface in small dump cars called skips. These skips usually contain one and one-half cubic yards of earth, but the average rate of contents for a certain period for all the ore mined is the figure at which the miners' pay is calculated. This average basis is determined periodically, usually monthly, by the mine superintendent or engineer, the mine usually reserving a small percentage of safety so that it will not overpay the men.

The contract rate of pay is so much per cubic yard, less the amount charged to the crew for the explosives and small tools used. Therefore, by taking the number of skips produced by the crew during the month, multiplied by the average contents of the skips as determined by the mining superintendent, multiplying this by the amount per cubic yard to be paid to the miner and deducting the amount of explosives and materials used, we would get the total amount due to the crew for the ore mined during the

period; and dividing this total by the number of men in the crew, we would determine what each man is to receive. This method is found to be satisfactory, as the men have an incentive to work hard and it is surprising what a difference there is in the work the good miners can turn out and that of the poor miners. The men on their own contract are not paid for their shoring of the runways or blasting of the rock; they are compelled to do this on their own time and at their own expense, so that often the difference in the showings between crews is due to the character of the ore in which they mine. The miners are usually paid by cheque, there being no law in Minnesota, where a great part of the iron mining is done, to the contrary. The miners keep a careful tally of the skips that they produce during the period and can come very close to telling the payroll clerk how much they have coming to them.

A peculiar feature of the payroll system, as used in iron mining on the big ranges in Minnesota, is the assigning by the miners of the pay due to them to the banks, in order to secure their pay before it is due. The miners do this by means of assignments, which merely transfer their interest in their pay to the bank to the extent of the loan. Miners as a rule seem improvident and cannot await the month necessary in order to secure their money from the company. They get a slip from the pay clerk stating the amount of money that they have coming to them, sign an assignment, take it to the bank, and the bank gives them the money, the company at the same time acknowledging this as a lien on the miner's next pay cheque.

The iron mining companies pay their men only once a month, and this is to be regretted, as the banks in the small towns in Minnesota charge the miners five per cent for these assignments regardless of the time for which they run. This time is usually about two weeks and it is easy to see that the rate charged by the bank would be called usury in most states, although it is within the law of Minnesota. Some companies even allow the banks to charge as much as ten per cent, splitting the interest charges with the bank half and half.

A complete and satisfactory system of stock and material records must be kept at the mines. This is due in part to the fact that the miners are charged for the explosives, material and small

tools that they use in mining. The miners are also charged with air drills, etc., that they use in mining, but if they return them in fairly good condition, they are not charged on their payroll for these items as they are for the explosives, etc. It is best to have a good storehouse with a storekeeper in charge and to have the men present orders o. k.'d by the superintendent for what they wish and also to have them sign for the materials as they take them away.

In iron mining royalties are usually paid on the basis of the ore mined; therefore, it is necessary as the ore is mined to set up a reserve equal to the amount of royalties per ton multiplied by the number of tons produced during that month, the charge being made to cost of operation and the credit to the reserve for royalties. Some mines carry their own accident insurance instead of taking out insurance. They do this by setting up a reserve equal to an amount usually about one cent a ton and charging this to cost of operation. This rate may vary in different mines but usually is about the same as that charged by an insurance company.

Construction records dealing with any new work completed at the mines should be kept at the mine office, and monthly reports should be made to the main office of all the work in progress and what materials and supplies have been expended thereon.

The taxes for the year are estimated in advance, split into twelve parts, and one-twelfth is charged to each month's operation. This figure is added to the cost sheet at the general office. Therefore, the cost sheet shows not only the cost of mining but the total cost of the ore up to the time it is shipped. As part of the cost sheet or as a separate record the mines also submit to the general office detailed account of all materials and supplies used during the month and on hand at the end of the month.

During the winter months on the iron ranges, when the ore cannot be shipped to the eastern ports because the lakes are frozen over, the mines pile the ore at the mouth of the mine in what is called a stockpile. The contents of this stockpile are estimated by taking the number of skips or buckets full of ore sent up from the mine and multiplying this by the average contents of the skip as determined by the mine superintendent. As stated previously, mines always allow themselves a little leeway in estimating the average cubic contents of the skips. Therefore, it is found that

in the spring, when the stockpile is shipped away from the mine, it always produces in actual ore more tonnage than was estimated.

In the monthly cost statement, the estimated number of tons produced is used during the winter months and in the spring the excess of ore found in the stockpile is added to the yearly accumulated tonnage without placing it in the monthly figures. It has been found that this is the only equitable way of treating the stockpiles. When the ore is placed in stockpiles during the winter months, there is no actual charge incurred for loading the ore from the stockpiles into the freight cars. This expense is actually incurred later in the year. Nevertheless, it is best to charge the expense of loading the ore into cars even during the period when it is placed in stockpiles, the rate being the average cost per ton for the past season. Thus a reserve is set up and, when the shipping begins in the early spring, the charge of loading the ore from the stockpiles is not charged to current operation but is charged to this reserve, any balance that is left in the reserve after all the ore is mined being closed to profit and loss.

In some cases it has been found more practicable to mine by the open-pit method than by digging vertical shafts and horizontal runways. Under the open-pit system, the surface earth is removed by steam shovels and when the main ore body is reached this also is removed by steam shovels. This method can only be used where it is found that the iron ore body is close to the surface of the ground, as the cost of removing the surface earth is high. After the surface earth is removed, the cost of mining the ore is very cheap compared with the shaft method. This is due to the fact that there are no expensive shafts or shaft machinery needed, except for a small shaft and a few runways which are sunk in order to drain and pump off the water from the open pit. One disadvantage of the open-pit method is that it is not always possible to operate the pit in winter because of the severe weather, but it is usually possible to remove surface earth when no other work can be done. The accounting for open-pit mining is practically the same as for the shaft method, except, of course, the items entering into the costs are changed to correspond to the method used. The cost of removing the surface earth is set up as a deferred charge to operations and is written off at a rate per ton determined by dividing the total cost of remov-

ing the earth by the total number of tons of ore available. The cost per individual of the labor under the open-pit method is more costly because a higher class of workmen is required; but fewer men are needed and the labor cost per ton is small compared to that of the shaft method of mining.

The foregoing are the most important items to be considered in iron mining accounting. The balance of the accounting system is the same generally as that in other kinds of business.

The Journal of Accountancy

Published monthly for the American Institute of Accountants by
The Ronald Press Company, 20 Vesey Street, New York, N. Y.
Thomas Conyngton, president; L. G. Henderson, secretary;
Hugh R. Conyngton, treasurer

A. P. RICHARDSON Editor

EDITORIAL

The Indispensable Accountant

It is regrettable that American accountants generally have not had an opportunity to review the minutes of evidence before the British royal commission on income tax. From beginning to end the minutes are filled with matter of the utmost importance to all persons concerned in income-tax practice, and there are frequent references to accounting which should be carefully considered by every accountant.

It is not possible to reproduce even a summary of the evidence, but there are one or two points which we feel cannot be passed by without notice. Elsewhere in this issue of The Journal of Accountancy we reprint a memorandum by the board of inland revenue on the subject of depreciation and obsolescence of plant and machinery. The value of this document is obvious.

Some of our legal friends have been inclined to take umbrage at the assertions frequently made in this magazine that no one can be expected to prepare income-tax returns so well as the accountant. Our critics say that income-tax law is law and therefore should be interpreted by lawyers.

A. M. Bremner was called to give evidence before the royal commission because, as it appears in the minutes, he was regarded as the leading legal authority on income-tax law; and his views on this point are therefore especially interesting to accountants.

We give questions and answers, the questioner being a well-known accountant and a member of the commission.

I suggest to you that to those who are doing the daily work of income tax it is not quite so confused as you suggest?

I agree with you entirely, and that is one of the things that has been

passing through my mind. The inland revenue officials unconsciously underrate the difficulty of dealing with this act.

Why?

From the time when they are quite young they begin to study the income-tax law. They have the great advantage of being steeped in the practice, and therefore they acquire in time a very considerable knowledge of income-tax law, and when you have a very considerable knowledge of any subject, you are apt to think it is not so difficult after all. The people who know most about the income-tax law, after the income-tax officials—I think I must say after them, because they do nothing else and it is their business—are the accountants. The accountants know much more about the income-tax law than the lawyers do. It would not pay the lawyers to be daily studying income-tax law. They have got the affairs of their clients to look after; but the accountant, by his long experience, knows exactly what the surveyor will pass and what he will not pass.

Not always.

Chairman: You are paying a very great compliment to your examiner?

I have often said it, and when people come to me in a difficult case, I say, "Would you kindly bring me the accountant?" Then the next thing I ask for is the correspondence between the accountant and the surveyor. I attach the greatest importance—and I should like to take this opportunity of saying it—to what passes between the accountants and the surveyors with a view to adjusting the difficulties as to figures and accounts; because if you had to try these appeals by going through every item in a profit and loss account on both sides, calling evidence as we do in a law court, and going through it in detail and giving the evidence on each item, the thing would never end. The great practical advantage of the accountants and the surveyors getting together is that they do not differ except on questions of principle. Of course they often differ, or sometimes they differ on a question of principle, and then we have to go to the law courts to fight it out, but I am enormously assisted in my practice by the custom of the accountant and the surveyor getting together and settling all the figures subject to any points of principle. That facilitates the hearing of appeals immensely. I go to the commissioners and say, "There are some complicated figures; do not trouble about them; we can adjust those; you give your decision on the question of principle," and that facilitates things wonderfully. Personally I dislike figures very much, and I am quite unable to deal with them, and I am delighted to put the figures on to more competent shoulders, but it is a very great advantage indeed; in fact, I doubt if you could collect the income tax if the surveyor and accountant did not get together and settle the figures.

Mr. McLintock: There is just one point with regard to the evidence given on appeal. Do you know that accountants conduct a great many appeals before the general commissioners and the special commissioners as well?

I do.

Do you think that is an advantage?

I do; I think that is quite right, because you may have an appeal which depends more upon figures than it does upon some principle of law; and I think it is an advantage that accountants should in such cases be able to conduct an appeal.

Clarity of Diction

Criticism is not infrequently made of accountants' certificates, and as bankers have more occasion to consider these certificates than others it is perhaps natural that more of the criticism should come from them than from any other class of the community.

Some go so far as to say that accountants should never give any sort of qualified certificates, forgetting that in many cases the accounts submitted are those of the client, and the duty of the accountant is clearly to certify whether or not those accounts are a full and fair disclosure of the financial position and if not to indicate in what respect they fall short of being such a disclosure.

Others who admit that qualified certificates are sometimes necessary are insistent that the language of any qualification should be so clear and specific that its significance would be obvious to any one on the most hurried reading. With these it is possible to agree to this extent: that every qualification should be clear and not so involved in language as to leave any doubt of its meaning in the mind of the ordinarily intelligent reader.

It must be admitted that accountants sometimes fall short of this standard, but in this they are not alone. Our attention was attracted to a recent prospectus containing the following clause:

> Neither the company nor any subsidiary will mortgage or pledge any of their real or personal property now owned or hereafter acquired. This covenant shall not prevent the company or any subsidiary from purchasing property subject to a mortgage or from creating a purchase money mortgage to the extent of 75 per cent of the fair value of the property purchased, nor from pledging as securities for loans made to it in the regular and current conduct of its business, accounts receivable or other liquid assets or stocks, bonds or other securities owned by it other than stocks or securities of subsidiary or controlled companies.

The first sentence seems to be clear and complete in itself and to give very real protection to intending investors. The first part of the second sentence also seems reasonable and it is not until towards the end of a long sentence that one realizes that the protection indicated by the first sentence is steadily whittled away in the

second. We have no doubt that this statement was made without the slightest intention to deceive or mislead, but we are equally convinced that many people would accept the first sentence at its face value.

In no class of the community is clarity of statement more important than among accountants, but if some fall short of the ideal they may at least console themselves with the knowledge that well-known bankers, advised by eminent counsel, sometimes err with them.

Depreciation Rates

In a course of evidence before the British royal commission on income tax, the following valuable memorandum on the subject of allowances for depreciation and obsolescence of plant and machinery was presented. The matter contained in the memorandum will be of much interest to readers of The Journal of Accountancy:

INCOME TAX

Memorandum by the Board of Inland Revenue on the subject of allowances for depreciation and obsolescence of plant and machinery, etc.

Wear and Tear Allowances—Legal Position

(1) The customs and inland revenue act, 1878, section 12, authorizes a deduction in the assessment of profits of such an amount as the income-tax commissioners concerned "may think just and reasonable as representing the diminished value by reason of wear and tear during the year of any machinery or plant used for the purposes of the concern." This deduction is in addition to the allowance made in respect of the cost of repairs to the machinery or plant.

(2) There is no statutory limit to the amount which the income-tax commissioners may allow in any year, but the aggregate amount of the deductions from first to last must not exceed the actual cost of the machinery and plant to the person by whom the concern is carried on.

(3) It may happen that the assessment on the profits of a trader for a particular tax year is nil, or is less than the amount of the wear and tear allowance for that year, so that he cannot get the full deduction from that year's assessment to which he would otherwise have been entitled; in such a case that part of the allowance to which effect cannot be given is carried forward and added to the allowance for the next year, and so on for succeeding years. (Finance act, 1907, section 26 (3).

Rates Agreed for Certain Trades

(4) Although no fixed scale of allowance is prescribed by law, definite rates of depreciation on different classes of machinery have been agreed upon for uniform application—subject to the concurrence of the respective bodies of income-tax commissioners—in a number of important industries as the result of applications by representatives of the industries to the board of inland revenue. Although these allowances have been generally adopted and accepted by the taxpayers, the power to appeal to the board of referees (see paragraph 5) will not be affected by any such agreement.

A schedule of these rates forms part of the present statement.

Appeal to Board of Referees

(5) The finance act, 1918, section 24 (1) provides that in cases affecting a class of trade or business the question of the amount to be allowed for wear and tear may be carried from the income tax commissioners to the board of referees. Application in such a case has first to be made to the commissioners of inland revenue, and those commissioners refer the case to the board of referees. If the board of referees are satisfied that the application is made by or on behalf of any considerable number of persons engaged

in any class of trade or business, they consider the case and determine the amount of the allowance.

Income Tax Authorities Concerned

(6) The authorities who have duties to perform in connection with wear and tear allowances are the commissioners of inland revenue, the income-tax commissioners and the board of referees.

The Commissioners of Inland Revenue

are civil servants and constitute the statutory board entrusted with the collection and management of inland revenue. They are responsible to the chancellor of the exchequer, and are represented in the numerous districts into which the country is divided by their surveyors of taxes (who are also salaried civil servants).

The Income-Tax Commissioners

With the exception of the special commissions of income tax, the commissioners concerned (who are more generally known as the district commissioners of taxes) are local bodies which act only in their respective areas (some 700 in number). They are not salaried officials, but are representative residents in the locality, and are recruited from the land tax commissioners named in a statutory list which is from time to time renewed by act of parliament. Their functions include the making of assessments, the hearing of appeals and the allowance of deductions for wear and tear.

The special commissioners of income tax are a body of salaried officials with similar powers, but acting (for the most part) only in those cases where the taxpayer elects to be dealt with by them instead of by the district commissioners.

The Board of Referees

are a central body of business men which was set up in connection with the excess profits duty. The names of the existing members of the board are given in a footnote.* Their only duty in connection with income tax is to deal with applications for the determination of wear and tear allowances where those applications are made by a considerable number of persons engaged in a particular class of business. (See paragraph 5.)

Replacement of Obsolete Machinery or Plant

(7) In addition to the allowance for wear and tear of plant and machinery there has been in operation since 1897 an allowance for obsolescence, and this allowance has been made statutory by section 24 (3) of the finance act, 1918.

The necessity for this allowance arises from the fact that machinery has frequently to be replaced, before it is worn out, owing to its having become obsolete and incapable of competing with more up-to-date machinery. Accordingly, where new machinery is introduced in place of machinery not wholly worn out, an allowance is made, as a deduction from the profits of the year, of so much of the cost of replacement as is equivalent to the written down value of the machinery replaced less any sum realized by the sale of it—the balance of the cost of the new machinery being an addition to the capital of the business.

For example, from the value of a machine which originally cost £1,000, wear and tear allowances have been made year by year until they have aggregated £600, so that the written down value of the machine stands at £400. The trader now considers that the machine is obsolete, scraps it and replaces it by an up-to-date machine which costs £1,400. He sells the old

* In the list appear 27 names. There are nine accountants in the number.

one for £50. He is entitled to charge as a trade expense incurred in the year in which the replacement is made the sum of £350; that is—,

Original cost of the machine replaced................		£ 1,000
Less (a) aggregate amount of wear and tear allowances already made in respect of the machine......	£600	
(b) sum realized by its sale.....................	50	
		650
Amount treated as trade expense in year of replacement		£ 350

Assuming the total written down value of the trader's plant and machinery before the sale of the obsolete machine to be £10,000, future wear and tear allowances will be made upon a value of £11,000, thus—

Written down value of total plant, etc................	£10,000
Deduct written down value of the obsolete machine....	400
	£ 9,600
Add cost of new machine........................	1,400
	£11,000

The obsolescence allowance is not made in quite the same way as the wear and tear allowance under paragraph I, for the latter is by statute an allowance from the assessment after the three years' average is struck. Thus the wear and tear allowance applicable to the year 1918-19 would be given as a deduction from the gross assessment for 1918-19 as follows:

Trading profits (before allowing wear and tear)—

1915—Loss	£ 5,000
1916—Profit	10,000
1917—Profit	13,000
	3) 18,000
Gross assessment 1918-19..........................	£ 6,000
(If the total wear and tear allowance due for the year 1918-19 were £6,500, a sum of £6,000 would be allowed against the 1918-19 assessment, and the balance of £500 carried forward for deduction in future years.)	
Wear and tear allowance..........................	£ 6,000
Net amount on which tax is payable for 1918-19.....	nil

An allowance for obsolescence in 1918 of, say, £10,000 would, however, be a deduction from the commercial profits of 1918, turning them from a profit of say, £9,800 to a loss of £200. The first assessment to be affected would be that of 1919-20, as follows:

Profits 1916	£10,000
1917	13,000
1918—Loss	200
	3)22,800
Gross assessment 1919-20........................	£ 7,600
Less allowance for wear and tear, say, £6,800 for 1919-20, plus the unexhausted balance carried forward from 1918-19, £500 = ...	7,300
Net amount on which tax is payable for 1919-20....	£ 300

The business year 1918 would also come into the average for the tax years 1920-21 and 1921-22, by which time the allowance would have had its full effect.

Cost of Renewals as an Alternative Method

(8) As an alternative to the allowance for wear and tear and obsolescence of plant and machinery, the cost of renewing plant and machinery may be claimed as a deduction in the computation of income-tax liability under schedule D. When this course is preferred by the taxpayer the amount to be allowed is the actual cost of the new plant and machinery (excluding any part of such cost which is attributable to additions or improvements, i. e., to an increase in capital) after deducting the scrap value or realized price of the plant and machinery replaced.

Example (a)—A machine which originally cost £1,000 is worn out and replaced by a machine of similar power or size or capacity which now costs £1,500. The whole of this expense of £1,500 is allowable from the profits of the year in which it is incurred.

Example (b)—A machine which originally cost £1,000 is worn out and replaced by one of greater power or size or capacity costing £2,500. The amount to be allowed as an expense is in this case not the full £2,500, but only the cost of replacing the old machine by one of similar power or capacity—say £1,500.

Although this method of allowance is alternative to the wear and tear allowance for the same class of plant, the two principles may run concurrently for different classes of assets in the same business. For example, the wear and tear allowance may apply to fixed machinery, while the renewal method is used for loose plant.

Buildings

9. In the computation of the profits of his business for assessment under schedule D, a trader is allowed to deduct as a trade expense his whole outlay on repairs, maintenance and insurance of his trade premises.

Where he owns the premises which he occupies for the purpose of his business, and therefore has to bear the income tax (schedule A) on those premises, he is also allowed a set-off in arriving at the liability under schedule D of the amount on which he has actually paid income tax (schedule A), i. e., of an amount equal to five-sixths of the full annual value of the premises. (This provision is, of course, necessary in order to prevent double taxation of the same item, once under schedule D, and a second time under schedule A.)

But although an owner-occupier of trade premises has actually paid the schedule A tax on only five-sixths of the annual value, he is allowed (under section 24 (4) of the finance act, 1918) in the case of premises which are peculiarly subject to depreciation, viz.: mills, factories and other similar premises, to deduct the whole (six-sixths) of the annual value in com-

Schedule of Agreed Rates of Depreciation Referred to in Paragraph 4.

(See Paragraph 10 as to Special Allowance to meet exceptional wear and tear.)

Industry, &c.	Rate per cent.	Prime Cost or Written-down Value	Nature of Plant	Remarks
Electric light Undertakings	3 5	Written-down value " " "	Cables Plant and machinery	
Flax spinning and linen weaving (Ireland)	7½	Written-down value	Machinery and plant (except accessory plant such as pirns, pirn cages, spools, belting, driving ropes, damask cards, designs, patterns, models, furniture and fixtures).	
Flour milling	5 7½	Written-down value " " "	Engines, boilers and main shafting. Other machinery.	
Gas undertakings other than those owned by municipal or other public authorities	3 10	Written-down value " " "	Gasholders. Meters, cookers and gas fires.	
Motor omnibuses	20	Written-down value	Motor omnibuses	(a) The rate of 20 per cent is to be re-considered at the expiration of four years, commencing with 1916-17. (b) This rate does not apply to commercial motor vehicles.
Paper mills	5 7½	Written-down value " " "	Machinery working day only Machinery working day and night	
Printing	5 7½	Written-down value " " "	Engines, boilers and shafting. Printing and binding machines.	

Industry, &c.	Rate per cent	Prime Cost or Written-down value	Nature of Plant	Remarks
Railway wagons	5	Written-down value	Railway wagons	(a) The allowance applies to all wagons owned by traders. (b) In the case of railway companies the method adopted is to allow the actual cost of renewals year by year.
Shipping	4	Prime cost	Steamships.	With regard to ships purchased at second-hand at prices in excess of the written-down value at the date of purchase, the following arrangements have recently been made: (a) The allowance is made on the actual cost price of the ship to the owner for the time being without regard to the prime cost to a previous owner. (b) The rate of depreciation allowable is calculated by reference to the reasonable expectation of the life of the ship at the date of purchase from the previous owner.
	3	Prime cost	Sailing vessels.	
Steel manufacturers	15	Written-down value	Machinery and plant used in the manufacture of steel.	The rate of 15 per cent represents 5 per cent for normal wear and tear, and 10 per cent for the additional wear and tear arising from war conditions.
Timber merchants, saw millers, and manufacturers of timber goods.	5	Written-down value	Engines, boilers and main shafting.	
	7½	" " "	General saw-milling plant and machinery.	
	20	" " "	Traction engines, tractors, motor-cars, and haulage plant.	
Tramways	..	......	Permanent way.	An allowance per mile of track based upon the estimated life of the permanent way.
	3	Written-down value	Cables.	
	7	" " "	Cars and other rolling stock.	
	5	" " "	General plant and machinery, including standards, brackets, and work-shop tools.	

puting his profit for assessment under schedule D. That is to say, he is allowed every year absolutely tax free a sum equal to one-sixth of the annual value of the mill or factory to provide a sinking fund to replace the building.

The operation of the allowance may be seen from the following example:

Old method:

Year	Profits		Net schedule A assessment		
1915...........	£10,000	—	£ 600	=	£ 9,500
1916...........	11,000	—	500	=	10,500
1917...........	14,000	—	1,000	=	13,000
					3)33,000
1918-19 assessment under the previous law..................					£11,000

New method:

Year	Profits		Gross schedule A assessment		
1915...........	£10,000	—	£ 600	=	£ 9,400
1916...........	11,000	—	600	=	10,400
1917...........	14,000	—	1,200	=	12,800
					3)32,600
1918-19 assessment under the law as now altered............					£10,867

Temporary Provisions Necessitated by War Conditions. Extra Wear and Tear

10. With the exception of the rates relating to the motor omnibus, saw milling and steel industries, the rates of depreciation given in the schedule were agreed upon under pre-war conditions.

Cases have arisen, especially since the commencement of the war, in which machinery is suffering exceptional wear and tear, owing, for example, to extra hours of running, the difficulty of obtaining material for effecting repairs, the rougher usage to which the machinery is subjected owing to the employment of unskilled labor, and the fewer opportunities available for having the machinery overhauled. In such cases applications for special rates of depreciation have been entertained; but, generally speaking, the circumstances of individual cases have been found to vary so widely as to render it impracticable to fix a uniform scale, and each application has been dealt with on its own merits.

Machinery Out of Use

11. Where machinery or plant has been temporarily out of use through circumstances attributable directly or indirectly to the present war, an allowance for depreciation is granted on the same lines as if the diminished value had actually been caused by "wear and tear during the year." (Finance act, 1918, section 24 (2.)

"Controlled Establishments"

12. In one class of case, namely, concerns which are "controlled" under the munitions of war act, 1915, the income-tax allowance has been temporarily extended, by the finance acts of 1916 and 1917, to include the deductions for "exceptional depreciation or obsolescence of buildings, plant or machinery" which are allowed for excess profits duty and munitions levy purposes.

This allowance prevents the hardship that would otherwise arise owing

to the circumstance that "controlled establishments," being held at the disposal of the government, may be required to alter completely the course of their business and to undertake exceptional expenditure which may be of little or no post-war utility to them, e. g., on machinery which may never be replaced, and to which therefore the ordinary obsolescence allowance would not be applicable. The finance acts of 1916 and 1917 accordingly authorize the income-tax commissioners to revise the income tax allowance so as to enable a deduction to be made from profits of the difference between cost and post-war value of installations and extensions (including buildings) which would not have been undertaken but for the war and the express requirements of the government.

Income-tax Department

Edited by Stephen G. Rusk

Judge Bourquin's decision, set forth below, affords an interesting comparison with the rule laid down in article 845 of regulations 45, that "for the purpose of computing invested capital, federal income and war profits and excess profits taxes are deemed to have been paid out of the net income of the taxable year for which they are levied."

This regulation, it will be remembered, permits the inclusion in invested capital of a reserve for income and profits taxes until the date or dates when payment thereof is made.

The judge states that the tax is not a debt in a strict sense, but immediately states that the obligation is of a higher nature than a debt, and in accordance with the latter statement makes the distributees of the corporation's assets liable to the extent of such distribution for the corporate tax under the trust fund doctrine.

Any obligation of a corporation of a higher nature than a debt should, of course, be treated as a liability, and accountants have recognized this principle when setting up a reserve for income and profits taxes.

This theory has been attacked in many instances where an employee's compensation was based upon the net earnings of the employing corporation. The employee has contended that the tax should not be deducted from net income in the computation of his compensation, as the tax applied against the year in which it was levied and not against the year in which the income accrued upon which the tax was based.

The decision seems to allay any doubt there may be as to when the debt applies, even though it may be included in invested capital until the time when it is paid.

(T. D. 3043, July 2, 1920)

Income tax—Retrospective law—Decision of court

1. An income tax may be and was imposed by retrospective law.

2. A tax is not a debt and the government is not a creditor in a strict sense. The obligation is of a higher nature than a debt.

3. Distributees without consideration of corporate assets, as stockholders in case of dissolution, are liable to extent of the distribution for corporate tax under the trust-fund doctrine.

The appended decision of the district court of the United States for the district of Montana, in the case of *United States v. John J. McHatton et al.*, is published for the information of internal revenue officers and others concerned.

DISTRICT COURT OF THE UNITED STATES, DISTRICT OF MONTANA

United States v. John J. McHatton et al. (May 6, 1920)

Bourquin, Judge: Herein, the demurrer to the complaint is overruled.

When the corporation was in being and at dissolution, it owed the duty to pay all taxes lawfully imposed upon it for income during its life, at any time. Taxes could be lawfully imposed by retrospective law, and were. If material, the law speaks of and from a time anterior to the dissolution, takes effect as though enacted prior to the dissolution. Taxes are not debts, nor government a creditor, in strict sense. They are of higher nature. But no reason is perceived why they are not within the principle that those who gratuitously receive a debtor's property, to the extent thereof are liable for his debts and obligations then inchoate or vested, within this principle otherwise known as the "trust fund" doctrine in respect to corporations.

Accordingly, when this corporation without consideration distributed part of its assets to these defendants, it was under obligation to plaintiff to pay any taxes that might thereafter be imposed. Defendants received the assets subject thereto and to the principles aforesaid. The obligation was contingent, the plaintiff's right inchoate. The contingency happened, the right vested. And the corporation's assets so distributed may be pursued in the hands of these defendants by virtue of the principles aforesaid.

In principle the case is very like the Brady case, 240 Fed., 665.

* * * *

The opinion of the attorney general cited in treasury decision No. 3044 is one of the examples of the great injustice wrought by too strict adherence to the letter of the income and profits tax law.

Here is a company which paid a tax on profits earned in a fiscal year ended September 30, 1918. The tax exceeded the profits earned in the two years ended September 30, 1919, because of a non-cancellable contract for purchase of material the company had at the time of the signing of the armistice. The value of the material contracted for was greatly reduced upon the cessation of hostilities, and as a result the company sustained a loss in its fiscal year ended September 30, 1919, which when added to the tax it paid on 1918 business resulted in a deficit on the two years' business.

The story is well told in the following decision, and should be carefully read by accountants.

The impression we get from a careful reading of the argumentative matter is that the attorney general interprets the intention of congress to be fully set forth by the language of the act, but overlooks the fact that it may have been intended to give relief to taxpayers whose exact condition it could not foresee.

It is lamentable that congress could not have provided enough administrative authority to relieve taxpayers from such conditions as are set forth in treasury decision No. 3044.

(T. D. 3044, July 9, 1920)

Income tax

Change in taxable year—Loss in inventory—Opinion of attorney general

1. The A company earned a large income during the fiscal year ended September 30, 1918, and suffered a net loss during the year ended September

30, 1919. The company in 1920 requested permission to change its accounting period for 1918 to the calendar-year basis, and then to be allowed to deduct the net loss from the taxable income for 1918, under section 204, revenue act of 1918. *Held* that the accounting period for which the tax liability had accrued and the method of accounting during that period were accomplished facts which could not thereafter be changed by the commissioner.

2. The company further contended that it was entitled to a deduction for inventory loss under subdivision 14, section 234(*a*), revenue act of 1918, because of certain non-cancellable contracts for the future delivery of material which were not completed by delivery prior to the termination of the fiscal year, the value of this material having been greatly decreased as a result of the signing of the armistice on November 11, 1918. *Held*, that as the company did not own the material on September 30, 1918, but had only a contract for its purchase, no deduction could be allowed as a loss on inventory based on such contracts.

Below is given a synopsis of an opinion rendered by the attorney general on May 28, 1920. The opinion is not to be published in full, as its publication might disclose unnecessarily the private affairs of the taxpayer. The following may be taken as a fair statement of facts to which the ruling applies:

The A company earned a large income during the fiscal year ended September 30, 1918, and suffered a net loss during the year ended September 30, 1919. The company is now requesting permission to change its accounting period for 1918 to the calendar-year basis, and then to be allowed to deduct a net loss for 1919 from the taxable income for 1918, under section 204, revenue act of 1918. As an alternative, it contends that it is entitled to a deduction for inventory loss under subdivision 14 of section 234(*a*), revenue act of 1918, because of certain non-cancellable contracts for the delivery of X material, which were not completed by the delivery of the X material prior to the termination of the fiscal year, the value of this material having been very greatly decreased as a result of the armistice signed on November 11, 1918. The commissioner of internal revenue has ruled that he is without power to now allow the requested change in an accounting period for 1918, or to allow the deduction for inventory loss. The company in its manufacture uses unusually large quantities of certain material. During the war the company's plant was entirely devoted to war production. In August, 1918, acting upon information obtained that there would be a shortage in X material, and that it was important therefore for the company to buy for its current needs, this company entered into contracts for the future delivery of a large quantity of such material, the quantity ordered being reasonably necessary for a six months' supply on the basis of the then current government demand for its product. On the signing of the armistice the market price of this material fell to a very low figure. The company's contracts were legally binding and non-cancellable, and as a result the company, subsequent to November 11, 1918, suffered a loss on these contracts. The company's taxable year ended September 30, 1918. Its earnings for that year were considerable and the tax levied thereon correspondingly large. In making its tax return the company paid a portion of the tax assessed and filed a claim in abatement for the balance, asking that this claim be allowed as a loss on inventory, because of this loss on X material arising from contracts made during 1918. This claim was denied by the income-tax unit apparently on the ground that the claim could not be treated as a loss on inventory, because X material contracts for future delivery entered into in 1918 were not inventoried September 30, 1918.

Since its claim was denied the company's 1919 taxable year ended

September 30, 1919. It later definitely ascertained that during its taxable year 1919 the company suffered an operating loss, a large part of which was due to the money losses actually suffered on the above-mentioned X material contracts of 1918. Coupling together these two taxable years in this manner the company's tax would exceed the earnings for these two years. The fiscal year ending September 30 had been determined and fixed at the time of its incorporation in 1912, and section 204(*b*) was enacted subsequent to the date when, under existing regulations, it could have secured a change in its accounting period. Attention was directed to the fact that the company incurred its losses on these contracts, not because of any error of business judgment, but because it acted upon the information which it received from the War Industries Board and in a desire to hasten production. Further, because of the slowness with which the material was being delivered it was not possible to make contracts therefor containing cancellation privileges, nor was it possible to obtain deliveries short of several months after order.

Upon substantially these facts the following questions were submitted to the attorney general:

First. Does the statute authorize the commissioner to approve a change by this company at this time (January, 1920) in its accounting records for the fiscal year ended September 30, 1918, so that its accounting period for 1918 will be changed to a calendar-year basis, solely because of a tax advantage?

Second. Are the regulations promulgated by the commissioner with the approval of the secretary, requiring notice of a change of accounting periods and forbidding retroactive changes, valid regulations?

Third. Does the statute authorize a deduction by this company under section 234(*a*), subdivision 14, by treating this loss on the X material contracts as a loss which is of the "character" of an inventory loss?

The attorney general disposed of the questions as follows:

It will be seen that the company's taxes for 1918 have been assessed upon the basis of its return made as of September 30, 1918, the close of its fiscal year. In other words, its taxes have been assessed on the basis of its financial condition on that date as compared with its financial condition twelve months previously. The result reached was based—in part, of course—upon an inventory of all its property owned at that date. It then had outstanding contracts for the purchase and delivery of X material to be used in its manufacturing operations during succeeding months. The amounts which would be payable under these contracts upon delivery of the X material were not listed as liabilities, nor was the X material which was to be thereafter delivered included in the inventory of property owned by the company. At that time the war was in progress. The company was not using X material in carrying out contracts with the government. It was, however, using it in the manufacture of articles which were sold to and used by others who had war contracts with the government. The immediate demand for and value of the products in which X material was used depended very largely upon the continuance of the war. When the armistice was signed in November this demand ceased and the value of the X material which the company had contracted to buy immediately dropped, making it inevitable that when the X material should be delivered and paid for a heavy loss would immediately ensue.

It is clear that the assessment was made upon a return which clearly reflected the income and profits of the company on September 30, 1918. The theory of the income-tax laws is that income and profits are to be determined and taxed annually. Ordinarily, therefore, when he pays taxes for a given year upon the net income shown by a proper accounting at the end of that year he is not entitled to relief even though it happens that he suffers a net loss during the succeeding year in excess of the net income for the first year.

The revenue act of 1918 was not, in fact, passed until February, 1919. During the time that it was under consideration by congress the armistice had been signed. There were many individuals and corporations in the country conducting business requiring large capital and dependent in large measure upon the continuation of the war. It was therefore obvious when the act was passed that much property—such as plants, buildings, machinery and equipment valuable for war work—had been at once greatly reduced in value by the signing of the armistice. It was also evident that business profitable because of the war would, in many instances, be conducted, if at all, during the following year at a loss. Congress apparently felt that persons and corporations so situated should be given some relief. Accordingly, section 204(*b*) is as follows:

"If for any taxable year beginning October 31, 1918, and ending prior to January 1, 1920, it appears upon the production of evidence satisfactory to the commissioner that any taxpayer has sustained a net loss, the amount of such net loss shall, under regulations prescribed by the commissioner, with the approval of the secretary, be deducted from the net income of the taxpayer for the preceding taxable year; and the taxes imposed by this title and Title III for such preceding taxable year shall be redetermined accordingly."

Net loss as used in this provision is defined in section 204(*a*) to be only "net losses resulting from either (1) the operation of any business regularly carried on by the taxpayer, or (2) the bona fide sale by the taxpayer of plant, buildings, machinery, equipment, or other facilities, constructed, installed, or acquired by the taxpayer on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war." It will be seen that this relief was not extended to all corporations which had been assessed for taxes during the year 1918, but is limited to those whose fiscal or tax year began after October 31, 1918. Apparently, so far as this provision was concerned, congress decided to leave without relief those individuals and corporations whose taxes for 1918 had been assessed upon the basis of a tax year ending prior to the date mentioned—that is, prior to the month in which the armistice was signed. The fiscal or tax year of the A company ended September 30, 1918. It clearly, therefore, did not come within the terms of section 204, and the question is whether it can now be permitted to bring itself within the terms of that section by changing its accounting period or tax year.

Section 212 of the act of 1918, applying to individuals, but made applicable to corporations by section 232, provides:

"(*b*) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year, as defined in section 200, or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

"If a taxpayer changes his accounting period from fiscal year to calendar year, from calendar year to fiscal year, or from one fiscal year to another, the net income shall, with the approval of the commissioner, be computed on the basis of such new accounting period, subject to the provisions of section 226."

This clearly expresses the purpose that if there is in the conduct of a business a regular accounting period the tax shall be computed for that period

and in accordance with the method of accounting regularly employed in keeping the books of the taxpayer, provided that method of bookkeeping clearly reflects the income. If the income is not thus clearly reflected, the commissioner is given authority to compute the tax in such manner as will clearly reflect the income. I am of opinion, however, that whether the regular method of keeping the books or some other method of computation is made the basis it is compulsory that the taxes be computed for the taxpayer's regular accounting period.

The A company's regular accounting period ended September 30, 1918. The assessment against it was made for a period of twelve months ending on that date, and was presumably based upon the method of accounting regularly employed by the company in keeping its books. The act of 1918 was not passed until some months after this date. The accounting period for which the tax liability had accrued, and the method of accounting during that period were accomplished facts which, in the very nature of things, could not thereafter be changed. Congress, of course, might have authorized a change and directed a recomputation of the taxes, but it did not do so. On the contrary, I think it clear that by limiting the relief granted by section 204 to taxpayers whose tax year should begin after October 31, 1918, it unequivocally expressed the intent that no taxpayer whose tax year for 1919 began prior to that date should take any benefit under section 204. To permit now, therefore, a change in the accounting period for 1918 of this company would be to bring it within the terms of section 204 in the face of the expressed intent of congress that the section should not apply to it. I am of the opinion that the commissioner is without power to permit the change of the accounting period as requested by the company.

Section 204, however, does not contain all the relief which congress thought should be given on account of losses resulting from the armistice. Section 234 (14) is as follows:

"(*a*) At the time of filing return for the taxable year 1918 a taxpayer may file a claim in abatement based on the fact that he has sustained a substantial loss (whether or not actually realized by sale or other disposition) resulting from any material reduction (not due to temporary fluctuation) of the value of the inventory for such taxable year, or from the actual payment after the close of such taxable year of rebates in pursuance of contracts entered into during such year upon sales made during such year. * * * (*b*) If no such claim is filed, but it is shown to the satisfaction of the commissioner that during the taxable year 1919 the taxpayer has sustained a substantial loss of the character above described, then the amount of such loss shall be deducted from the net income for the taxable year 1918, and the taxes imposed by this title and by title III for such year shall be redetermined accordingly."

This section, unlike section 204, applies to all corporations paying taxes for the year 1918. In the scope of the relief granted, however, it is narrower than that section. It permits a deduction from the net income shown for the year 1918 not of all losses sustained during the year 1919, but only such as result either from (1) a material reduction of the value of the inventory for the tax year 1918, or (2) from the actual payment after the close of the tax year 1918 of rebates in pursuance of contracts entered into during that year upon sales made during that year. On September 30, 1918, none of the X material on account of which losses were subsequently sustained had been delivered to the company, and hence none was included in the inventory on which the assessment for 1918 was made. The company did not at that time own this X material, and presumably much of it had not even been produced. The company did not own it but only had a contract for its purchase. It could not, therefore, have properly been included in an inventory of the company's property as of that date. It is not, as I understand, insisted

that if subsection 14(*a*) stood alone, the loss on this X material could be allowed as a reduction of the value of the inventory for 1918, but it is insisted that subsection 14(*b*) is broader in its scope, and that the expression therein "loss of the character above described" includes such a loss as that sustained on this X material. I am unable to agree with this insistence. Subsection 14(*a*) specifically describes the losses for which deductions may be made, and when (*b*) of the same subsection speaks of a "loss of the character above described," I do not think the language can be construed to include anything which is not included in (*a*). This view seems to me unavoidable when it is remembered that (*a*) provides for a claim in abatement to be made at the time of the filing of a return for 1918, that the act was not passed until February, 1919, after the time of many taxpayers for filing a return for 1918 had expired and after it was impossible for such taxpayers to file a claim in abatement at the time of filing their return. The provision in (*b*) was obviously for the benefit of taxpayers who had filed their returns before the act was passed, or who thereafter for any reason failed to file a claim in abatement at the time of filing returns. The two provisions manifestly apply to exactly the same losses, and these are specifically described in (*a*). The loss for which a deduction is now claimed does not consist of a reduction in the value of the inventory upon which the taxes for 1918 were assessed, and I am constrained to the opinion that it does not come within the terms of section 234 (14).

Answering the questions submitted specifically, I advise:

First: The statute does not authorize the commission to approve a change by this company at this time in its accounting records for the fiscal year ending September 30, 1918, so that its accounting period for 1918 will be changed to a calendar-year basis.

Second. The answer to question 1 is conclusive of this company's right to now change its accounting period for 1918, and a specific answer to question 2, which would involve a more extended examination of the regulations referred to, would therefore seem to be unnecessary.

Third. The statute does not authorize a deduction by this company under section 234, subdivision 14, by treating the loss on the X material contracts as a loss which is of the character of an inventory loss.

* * * *

Supreme court decisions are always edifying, and the one embodying treasury decision No. 3045 is especially so, even though voluminous.

It seems that if one deducts a dividend from the amount of his annual life insurance premium and remits to his insurance company the net amount, the company need not include the dividend as taxable income, but if one remits the total amount of the premium and the company then remits to him the amount of the dividend, the company must include the amount of the dividend as taxable income.

This fact, together with many others of interest with reference to mutual life insurance companies, will be found in the following decision, and we recommend a careful reading of the opinion of the United States supreme court delivered by Justice Brandeis.

This opinion was rendered upon an action brought under the law of October 3, 1913:

(T. D. 3046, July 19, 1920)

Income tax—Act, October 3, 1913—Decision of supreme court

1. *Excess in Premium*

It is of the essence of mutual insurance that the excess in the pre-

mium over the actual cost as later ascertained shall be returned to the policyholder.

2. *Premium Receipts Excluded from Gross Income.*

Section II G (*b*) of the act of October 3, 1913, excludes from gross income those premium receipts which are actually or in effect paid by applying dividends.

3. *Basis of Exclusion.*

The congress used the words "shall not include" as applied to the annually ascertained over-payments of premium paid back or credited to the policyholder, because it eliminated them from the aggregate of taxable premiums as being the equivalent of abatement of premiums.

4. *Object of the Noninclusion Clause.*

The noninclusion clause in the act of October 3, 1913, was framed to define what amounts involved in dividends should be "nonincluded" or deducted, and thus to prevent any controversy arising over the questions which had been raised under the act of 1909. (See *Mutual Benefit Life Insurance Co. v. Herold,* 198 Fed., 199.)

5. *Receipts of Net Premiums the Basis of Taxation.*

Congress has acted with entire consistency in laying down the rule by which in computing gross earnings certain amounts only are excluded. The principle applied is that of basing the taxation on receipts of net premiums, instead of on gross premiums. The amount equal to the aggregate of certain dividends is excluded, although they are dividends, because by reason of their application the net premium receipts of the tax year are to that extent less.

6. *Fraternal Life Insurance.*

Fraternal life insurance has been exempted from all income taxation because, as originally devised, it had in it only the element of protection. The premiums paid by the member were supposed to be sufficient, and only sufficient, to pay the losses which fell within the current year.

7. *Source of Dividend.*

The dividend of a life insurance company is made possible because the amounts paid in as premium have earned more than it was assumed that they would when the policy contract was made, or because the expense of conducting the business was less than it was then assumed it would be, or because the mortality—that is, the deaths in the class to which the policyholder belongs—proved to be less than had then been assumed in fixing the premium rate.

8. *Paid-up Policies.*

After a policy is paid up the element of investment predominates, and congress might reasonably regard the dividends substantially as profit on the investment.

9. *Deferred Dividend Policy.*

In the case of a deferred dividend policy the dividend represents in part what clearly could not be regarded as a repayment of excess premium of the policyholder receiving the dividend, for the "share of the forfeiture" which he receives is the share of the redundancy in premium of other policyholders who did not persist in premium payments to the end of the contract period.

10. *Fraternal Beneficiary Societies.*

Congress exempted certain co-operative enterprises from all income taxation, but, with the exception of fraternal beneficiary societies, it imposed in express terms such taxation upon "every insurance company."

11. *Participating Policies Issued by Stock Life Insurance Companies.*

The participating policies commonly issued by stock life insurance companies are, both in rights conferred and in financial results, substantially the same as the policies issued by purely mutual life insurance companies.

12. *Legislative History as an Aid to Construction.*

The legislative history of an act may, when the meaning of the words used is doubtful, be resorted to as an aid to construction; but no aid can possibly be derived from legislative history of another act passed nearly six years after the one in question.

13. *Judgment Affirmed.*

The judgment of the circuit court of appeals is affirmed.

The appended decision of the Supreme Court of the United States in the case of the Penn Mutual Life Insurance Company v. Ephraim Lederer, collector of internal revenue, is published for the information of internal revenue officers and others concerned.

SUPREME COURT OF THE UNITED STATES. No. 499.
OCTOBER TERM, 1919

The Penn Mutual Life Insurance Company, petitioner v. Ephraim Lederer, collector of internal revenue

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit

[April 19, 1920]

Mr. Justice Brandeis delivered the opinion of the court:

The Penn Mutual Life Insurance Company, a purely mutual legal reserve company which issues level-premium insurance, brought this action in the district court of the United States for the eastern district of Pennsylvania to recover $6,865.03, which was assessed and collected as an income tax of 1 per cent upon the sum of $686,503, alleged to have been wrongly included as a part of its gross income, and hence also of its net income, for the period from March 1, 1913, to December 31, 1913. The latter sum equals the aggregate of the amounts paid during that period by the company to its policyholders in cash dividends which were *not* used by them during that period in payment of premiums. The several amounts making up this aggregate represent mainly a part of the so-called redunancy in premiums paid by the respective policyholders in some previous year or years. They are, in a sense, a repayment of that part of the premium previously paid, which experience has proved was in excess of the amount which had been assumed would be required to meet the policy obligations (ordinarily termed losses) or the legal reserve and the expense of conducting the business.[1] The district court allowed recovery of the full amount with interest. (247 Fed., 559.) The circuit court of appeals for the third circuit, holding that nothing was re-

[1] The manner in which mutual level-premium life insurance companies conduct their business and the nature and application of dividends are fully set forth in *Mutual Benefit Life Ins. Co. v. Herold* (198 Fed., 199); *Connecticut General Life Ins. Co. v. Eaton* (218 Fed., 188); *Connecticut Mutual Life Ins. Co. v. Eaton* (218 Fed., 206).

coverable except a single small item, reversed the judgment and awarded a new trial. (258 Fed., 81.) A writ of certiorari from this court was then allowed. (250 U. S., 656.)

Whether the plaintiff is entitled to recover depends wholly upon the construction to be given certain provisions in section II G (*b*) of the revenue act of October 3, 1913, c. 16 (38 Stat., 114, 172, 173). The act enumerates among the corporations upon which the income tax is imposed, "every insurance company" "other than fraternal beneficiary societies, orders or associations operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under a lodge system." It provides (G (*b*) pp. 172-174) how the net income of insurance companies shall be ascertained for purposes of taxation, prescribing what shall be included to determine the gross income of any year, and also specifically what deductions from the ascertained gross income shall be made in order to determine the net income upon which the tax is assessed. Premium receipts are a part of the gross income to be accounted for.

In applying to insurance companies the system of income taxation in which the assessable net income is to be ascertained by making enumerated deductions from the gross income (including premium receipts), congress naturally provided how, in making the computation,[2] repayment of the redundancy in the premium should be dealt with. In a mutual company, whatever the field of its operation, the premium exacted is necessarily greater than the expected cost of the insurance, as the redundancy in the premium furnishes the guaranty fund out of which extraordinary losses may be met, while in a stock company they may be met from the capital stock subscribed. It is of the essence of mutual insurance that the excess in the premium over the actual cost as later ascertained shall be returned to the policyholder. Some payment to the policyholder representing such excess is ordinarily made by every mutual company every year; but the so-called repayment or dividend is rarely made within the calendar year in which the premium (of which it is supposed to be the unused surplus) was paid. Congress treated the so-called repayments or dividends in this way (p. 173):

(*a*) Mutual fire companies "shall not return as income any portion of the premium deposits returned to their policyholders."

(*b*) Mutual marine companies "shall be entitled to include in deductions from gross income amounts repaid to policyholders on account of premiums previously paid by them and interest paid upon such amounts between the ascertainment thereof and the payment thereof."

(*c*) Life insurance companies—that is, both stock and strictly mutual—"shall not include as income in any year such portion of any actual premium received from any individual policyholder as shall have been paid back or credited to such individual policyholder, or treated as an abatement of premium of such individual policyholder, within such year."

(*d*) For all insurance companies, whatever their field of operation, and whether stock or mutual, the act provides that there be deducted from gross income "the net addition, if any, required by law to be made within the year to reserve funds and the sums other than dividends paid within the year on policy and annuity contracts."

The government contends, in substance, for the rule that in figuring the gross income of life insurance companies there shall be taken the aggregate

[2] The percentage of the redundancy to the premium varies from year to year greatly in the several fields of insurance, and likewise in the same year in the several companies in the same field. Where the margin between the probable losses and those reasonably possible is very large, the return premiums rise often to 90 per cent or more of the premium paid. This is true of the manufacturers' mutual fire insurance companies of New England. See *Report Massachusetts Insurance Commissioner* (1913), Vol. I, p. 16.

of the year's net premium receipts made up separately for each policyholder.[3] The Penn Mutual Company contends for the rule that in figuring the gross income there shall be taken the aggregate full premiums received by the company less the aggregate of all dividends paid by it to any policyholder by credit upon a premium or by abatement of a premium, and also of all dividends whatsoever paid to any policyholder in cash whether applied in payment of a premium or not. The noninclusion clause (*c*) above excludes from gross income those premium receipts which were actually or in effect paid by applying dividends. The company seeks to graft upon the clause so restricted a provision for what it calls nonincluding, but which, in fact, is deducting all cash dividends not so applied. In support of this contention the company relies mainly, not upon the words of the statute, but upon arguments which it bases upon the nature of mutual insurance, upon the supposed analogy of the rules prescribed in the statute for mutual fire and marine companies, and upon the alleged requirements of consistency:

First. The reason for the particular provision made by congress seems to be clear: dividends may be made, and by many of the companies have been made largely by way of abating or reducing the amount of the renewal premium.[4] Where the dividend is so made the actual premium receipt of the year is obviously only the reduced amount. But, as a matter of bookkeeping, the premium is entered at the full rate and the abatement—that is, the amount by which it was reduced—is entered as a credit. The financial result both to the company and to the policyholders is, however, exactly the same whether the renewal premium is reduced by a dividend or whether the renewal premium remains unchanged, but is paid in part either by a credit or by cash received as a dividend. And the entries in bookkeeping would be substantially the same, because the several ways of paying a dividend are, as between the company and the policyholder, financial equivalents. Congress doubtless concluded to make the incidence the same also as respects income taxation. Where the dividend was used to abate or reduce the full or gross premium, the direction to eliminate from the apparent premium receipts is aptly expressed by the phrase "shall not include" used in clause (*c*) above. Where the premium was left unchanged, but was paid in part by a credit or cash derived from the dividend, the instruction would be more properly expressed by a direction to deduct those credits. Congress doubtless used the words "shall not include" as applied also to these credits, because it eliminated them from the aggregate of taxable premiums as being the equivalent of abatement of premiums.

That such was the intention of congress is confirmed by the history of the noninclusion clause (*c*) above. The provision in the revenue act of 1913 for taxing the income of insurance companies is in large part identical with the provision for the special excise tax upon them imposed by the act of August 5, 1909, chapter 6, section 38, 36 *Statutes*, 112. By the latter act the net income of insurance companies was also to be ascertained by deducting from gross income "sums other than dividends paid within the year on policy and renewal contracts," but there was in that act no noninclusion clause whatso-

[3] A separate account is kept by the company with each policyholder. In that account there are entered each year the charges of the premiums payable and all credits, either for cash payments or by way of credit of dividends or by way of abatement of premium.

[4] The dividend provision of the Mutual Benefit Life Insurance Co. involved in the Herold case, supra (198 Fed., 199, 204), was in part: "After this policy shall have been in force one year, each year's premium subsequently paid shall be subject to reduction by such dividends as may be apportioned by the directors." The dividend provision in some of the participating policies involved in the Connecticut General Life Insurance Co. case, supra (218 Fed., 188, 192), was: "Reduction of premiums as determined by the company will be made annually beginning at the second year, or the insured may pay the full premium and instruct the company to apply the amount of the reduction apportioned to him in any one of the following plans:" (Then follow four plans.)

ever. The question arose whether the provision in the act of 1913, identical with (*c*) above, prevented using in the computation the reduced renewal premiums instead of the full premiums, where the reduction in the premium had been effected by means of dividends. In *Mutual Benefit Life Insurance Company v. Herold* (198 Fed., 199), decided July 29, 1912, it was held that the renewal premium as reduced by such dividends should be used in computing the gross premium; and it was said (p. 212) that dividends so applied in reduction of renewal premiums "should not be confused with dividends declared in the case of a full-paid participating policy wherein the policyholder has no further premium payments to make. Such payments having been duly met, the policy has become at once a contract of insurance and of investment. The holder participates in the profits and income of the invested funds of the company." On writ of error sued out by the government the judgment entered in the district court was affirmed by the circuit court of appeals on January 27, 1913 (201 Fed., 918); but that court stated that it refrained from expressing any opinion concerning dividends on full-paid policies, saying that it did so "not because we wish to suggest disapproval, but merely because no opinion about these matters is called for now, as they do not seem to be directly involved." The noninclusion clause in the revenue act of 1913 (*c*) above was doubtless framed to define what amounts involved in dividends should be "nonincluded" or deducted, and thus to prevent any controversy arising over the questions which had been raised under the act of 1909.[5] The petition for writ of certiorari applied for by the government was not denied by this court until December 15, 1913 (231 U. S., 755)—that is, after the passage of the act.

Second. It is argued that the nature of life insurance dividends is the same, whatever the disposition made of them, and that congress could not have intended to relieve the companies from taxation to the extent that dividends are applied in payment of premiums and to tax them to the extent that dividends are not so applied. If congress is to be assumed to have intended, in obedience to the demands of consistency, that all dividends declared under life insurance policies should be treated alike in connection with income taxation regardless of their disposition, the rule of consistency would require deductions more far-reaching than those now claimed by the company. Why allow so-called noninclusion of amounts equal to the dividends paid in cash but not applied in reduction of renewal premium and disallow so-called noninclusion of amounts equal to the dividends paid by a credit representing amounts retained by the company for accumulation or to be otherwise used for the policyholders' benefit? The fact is, that congress has acted with entire consistency in laying down the rule by which in computing gross earnings certain amounts only are excluded; but the company has failed to recognize what the principle is which congress has consistently applied. The principle applied is that of basing the taxation on receipts of net premiums instead of on gross premiums. The amount equal to the aggregate of certain dividends is excluded, although they are dividends, because by reason of their application the net premium receipts of the tax year are to that extent less. There is a striking difference between an aggregate of individual premiums, each reduced by means of dividends, and an aggregate of full premiums, from which it is sought to deduct amounts paid out by the company which have no relation whatever to premiums received within the tax year but which relate to some other premiums which may have been received many years earlier. The difference between the two cases is such as may well have seemed to congress sufficient to justify the application of different rules of taxation.

There is also a further significance. All life insurance has in it the

[5] Substantially the same questions were involved also in *Connecticut General Life Ins. Co. v. Eaton* (218 Fed., 188), and *Connecticut Mutual Life Ins. Co. v. Eaton* (218 Fed., 206), in which decisions were not, however, reached until the following year.

element of protection. That afforded by fraternal beneficiary societies, as originally devised, had in it only the element of protection. There the premiums paid by the member were supposed to be sufficient, and only sufficient, to pay the losses which will fall during the current year, just as premiums in fire, marine or casualty insurance are supposed to cover only the losses of the year or other term for which the insurance is written. Fraternal life insurance has been exempted from all income taxation, congress having differentiated these societies, in this respect as it had in others, from ordinary life insurance companies. Compare *Royal Arcanum Supreme Council v. Behrend* (247 U. S., 394). But in level-premium life insurance, while the motive for taking it may be mainly protection, the business is largely that of savings investment. The premium is in the nature of a savings deposit. Except where there are stockholders, the savings bank pays back to the depositor his deposit with the interest earned less the necessary expense of management. The insurance company does the same, the difference being merely that the savings bank undertakes to repay to each individual depositor the whole of his deposit with interest, while the life insurance company undertakes to pay to each member of a class the average amount (regarding the chances of life and death); so that those who do not reach the average age get more than they have deposited—that is, paid in premiums (including interest)—and those who exceed the average age less than they deposited (including interest). The dividend of a life insurance company may be regarded as paying back part of these deposits called premiums. The dividend is made possible because the amounts paid in as premium have earned more than it was assumed they would when the policy contract was made, or because the expense of conducting the business was less than it was then assumed it would be, or because the mortality—that is, the deaths in the class to which the policyholder belongs—proved to be less than had been assumed in fixing the premium rate. When for any or all of these reasons the net cost of the investment—that is, the right to receive at death or at the endowment date the agreed sum—has proved to be less than that for which provision was made, the difference may be regarded either as profit on the investment or as a saving in the expense of the protection. When the dividend is applied in reduction of the renewal premium, congress might well regard the element of protection as predominant and treat the reduction of the premium paid by means of a dividend as merely a lessening of the expense of protection. But after the policy is paid up the element of investment predominates, and congress might reasonably regard the dividend substantially as profit on the investment.

The dividends, aggregating $686,503, which the Penn Mutual Company insists should have been "nonincluded," or more properly deducted, from the gross income, were in part dividends on the ordinary limited-payment life policies which had been paid up. There are others which arose under policy contracts in which the investment feature is more striking; for instance, the accelerative endowment policy or such special form of contract as the 25-year "6 per cent investment bond," matured and paid March, 1913, on which the policyholder received, besides dividends, interest and a "share of forfeitures." In the latter, as in "deferred dividend" and other semi-tontine policies, the dividend represents in part what clearly could not be regarded as a repayment of excess premium of the policyholder receiving the dividend. For the "share of the forfeiture" which he receives is the share of the redundancy in premium of other policyholders who did not persist in premium payments to the end of the contract period.

Third. The noninclusion clause here in question (*c*) above, is found in section II G (*b*) in juxtaposition to the provisions concerning mutual fire and mutual marine companies, clauses (*a*) and (*b*) above. The fact that in three separate clauses three different rules are prescribed by congress for the treat-

ment of redundant premiums in the three classes of insurance would seem to be conclusive evidence that congress acted with deliberation and intended to differentiate between them in respect to income taxation. But the company, ignoring the differences in the provisions concerning fire and marine companies, respectively, insists that mutual life insurance rests upon the same principles as mutual fire and marine, and that as the clauses concerning fire and marine companies provide specifically for noninclusion in or deduction from gross income of all portions of premiums returned, congress must have intended to apply the same rule to all. Neither premise nor conclusion is sound.

Mutual fire, mutual marine, and mutual life insurance companies are analogous, in that each performs the service called insuring wholly for the benefit of their policyholders, and not like stock insurance companies, in part for the benefit of persons who, as stockholders, have provided working capital on which they expect to receive dividends representing profits from their investment. In other words, these mutual companies are alike in that they are co-operative enterprises. But in respect to the service performed, fire and marine companies differ fundamentally, as above pointed out, from legal reserve life companies. The thing for which a fire or marine insurance premium is paid is protection, which ceases at the end of the term. If, after the end of the term, a part of the premium is returned to the policyholder, it is not returned as something purchased with the premium, but as a part of the premium which was not required to pay for the protection—that is, the expense was less than estimated. On the other hand, the service performed in level-premium life insurance is both protection and investment. Premiums paid—not in the tax year, but perhaps a generation earlier—have earned so much for the co-operators that the company is able to pay to each not only the agreed amount but also additional sums called dividends; and have earned these additional sums in part at least by transactions not among the members, but with others, as by lending the money of the co-operators to third persons who pay a larger rate of interest than it was assumed would be received on investments. The fact that the investment resulting in accumulation or dividend is made by a co-operative as distinguished from a capitalistic concern does not prevent the amount thereof being properly deemed a profit on the investment. Nor does the fact that the profit was earned by a co-operative concern afford basis for the argument that congress did not intend to tax the profit. Congress exempted certain co-operative enterprises from all income taxation, among others mutual savings banks; but with the exception of fraternal beneficiary societies it imposed in express terms such taxation upon "every insurance company."[6]

The purpose of congress to differentiate between mutual fire and marine insurance companies on the one hand and life insurance companies on the other is further manifested by this: The provision concerning return premiums in computation of the gross income of fire and marine insurance companies is limited in terms to mutual companies, whereas the noninclusion clause (*c*) above, relating to life insurance companies, applies whether the company be a stock or a mutual one. There is good reason to believe that the failure to differentiate between stock and mutual life insurance companies was not inadvertent. For while there is a radical difference between stock fire and marine companies and mutual fire and marine companies, both in respect to the conduct of the business and in the results to policyholders, the participating policy commonly issued by the stock life insurance company is, both in rights conferred and in financial results, substantially the same

[6] The alleged unwisdom and injustice of taxing mutual life insurance companies while mutual savings banks were exempted had been strongly pressed upon congress. Briefs and statements filed with senate committee on finance on H. R. 3321, sixty-third congress, first session, vol. 3, pp. 1955-2094.

as the policy issued by a purely mutual life insurance company. The real difference between the two classes of life companies as now conducted lies in the legal right of electing directors and officers. In the stock company stockholders have that right; in the mutual companies, the policyholders, who are the members of the corporation.

The Penn Mutual Company, seeking to draw support for its argument from legislation subsequent to the revenue act of 1913, points also to the fact that by the act of September 8, 1916, chapter 463, section 12, subsection second, subdivision c (39 Stat., 756, 768), the rule for computing gross income there provided for mutual fire insurance companies was made applicable to mutual employers' liability, mutual workmen's compensation, and mutual casualty insurance companies. It asserts that thereby congress has manifested a settled policy to treat the taxable income of mutual concerns as not including premium refunds; and that if mutual life insurance companies are not permitted to "exclude" them, these companies will be the only mutual concerns which are thus discriminated against. Casualty insurance in its various forms, like fire and marine insurance, provides only protection, and the premium is wholly an expense. If such later legislation could be considered in construing the act of 1913, the conclusion to be drawn from it would be clearly the opposite of that urged. The latter act would tend to show that congress persists in its determination to differentiate between life and other forms of insurance.

Fourth. It is urged that in order to sustain the interpretation given to the *noninclusion* clause by the circuit court of appeals (which was, in effect, the interpretation set forth above), it is necessary to interpolate in the clause the words "within such year," as shown in italics in brackets, thus:

And life insurance companies shall not include as income in any year such portion of any actual premiums received from any individual policyholder [*within such year*] as shall have been paid back or credited to such individual policyholder, or treated as an abatement of premium of such individual policyholder, within such year.

What has been said above shows that no such interpolation is necessary to sustain the construction given by the circuit court of appeals. That court did not hold that the permitted noninclusion from the year's gross income is limited to that portion of the premium received within the year, which by reason of a dividend is paid back within the same year. What the court held was that the noninclusion is limited to that portion of the premium which, although entered on the books as received, was not actually received within the year, because the full premium was by means of the dividend either reduced or otherwise wiped out to that extent. Nor does the government contend that any portion of a premium not received within the tax year shall be included in computing the year's gross income. On the other hand, what the company is seeking is not to have "nonincluded" a part of the premiums which were actually received within the year or which appear as matter of bookkeeping to have been received but actually were not. It is seeking to have the aggregate of premiums actually received within the year *reduced* by an amount which the company paid out within the year, and which it paid out mainly on account of premiums received long before the tax year. What it seeks is not a *noninclusion* of amounts paid in—but a *deduction* of amounts paid out.

If the terms of the noninclusion clause (*c*) above, standing alone, permitted of a doubt as to its proper construction, the doubt would disappear when it is read in connection with the deduction clause (*d*) above. The deduction there prescribed is of "the sums other than dividends paid within the year on policy and annuity contracts." This is tantamount to a direction that dividends shall not be deducted. It was argued that the dividends there referred to are "commercial" dividends like those upon capital stock, and

that those here involved are dividends of a different character. But the dividends which the deduction clause says in effect shall not be deducted are the very dividends here in question—that is, dividends "on policy and annuity contracts." None such may be deducted by any insurance company except as expressly provided for in the act in clauses quoted above (*a*), (*b*) and (*c*)—that is, clauses (*a*), (*b*) and (*c*) are in effect exceptions to the general exclusion of dividends from the permissible deductions as prescribed in clause (*d*) above.

In support of the company's contention that the interpolation of the words "within the year" is necessary in order to support the construction given to the act by the circuit court of appeals we are asked to consider the legislative history of the revenue act of 1918 (enacted Feb. 24, 1919, c. 18, 40 Stat., 1057); and specifically to the fact that in the bill as introduced in and passed by the house the corresponding section, 233 (*a*), contained the words "within the taxable year," and that these words were stricken out by the conference committee (report No. 1037, sixty-fifth congress, third session). The legislative history of an act may, where the meaning of the words used is doubtful, be resorted to as an aid to construction. (*Caminetti v. United States,* 242 U. S., 470, 490.) But no aid could possibly be derived from the legislative history of another act passed nearly six years after the one in question. Further answer to the argument based on the legislative history of the later act would therefore be inappropriate.

We find no error in the judgment of the circuit court of appeals. It is affirmed.

Students' Department

EDITED BY H. A. FINNEY

AMERICAN INSTITUTE EXAMINATION, MAY, 1920

In regard to the following attempt to present the correct solutions to the questions asked in the examination held by the American Institute of Accountants in May, 1920, the reader is cautioned against accepting the solutions as official. They have not been seen by the examiners, still less endorsed by them.

ACCOUNTING THEORY AND PRACTICE—PART I (Continued)

Question No. 8:

In preparation of consolidated returns under the federal income-tax law, on what basis would you apportion the tax among the several corporations?

Answer to Question No. 8:

The law states: "In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit, and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each."

As a public accountant preparing consolidated returns, I would have to be bound by the agreement of the companies or by the law. If, in making an agreement, the related companies asked my advice, I would point out that the net income assignable to each company would rarely be an equitable basis. The income and excess profits taxes are not based on net income alone but on the income and the ratio of income to invested capital. Where a saving is effected by filing consolidated returns, the saving is caused by the fact that one company's invested capital is so large in proportion to its profits that its tax liability does not extend into the upper bracket. By consolidating the returns, this company shares this advantage with its related companies. But if the tax is apportioned on the basis of net income it might easily happen that the company which furnishes the source of the tax saving would be apportioned a larger tax under the consolidated return than it would have been assessed under a separate return.

In most cases the fairest apportionment would be on the basis of the taxes which would be assessed against the related companies under separate returns. Thus if company A would have to pay $3,000 under a separate return and company B $7,000, the tax under the consolidated return could be fairly apportioned in the proportions of 3/10 and 7/10. The separate returns establish the relative tax liability, and it would seem fair to share the tax in this ratio.

Actuarial Questions (Optional)

Question No. 9:

The maximum sum insured under the soldiers' insurance with the government is payable \$57.50 a month for 20 years certain after death or disability. How can the equivalent sum payable in cash be found? Give the correct formula and explain why $12 \times 57.50 \times A_{20}$ differs from the equivalent cash sum.

Given A_{20} at $3\frac{1}{2} = 14.21$

Answer to Question No. 9:

The problem is indefinite as to whether the first monthly payment is due immediately after death or disability or one month thereafter. This is immaterial, however, if it is assumed that "the equivalent sum payable in cash" is payable on the date when the first monthly payment would have been made.

If the monthly payments were made they would constitute an annuity due of 240 rents of \$57.50 each, payable monthly. The formula $12 \times 57.50 \times A_{20}$ is not correct for two reasons.

In the first place, \$14.21, the value of A_{20} at $3\frac{1}{2}$ per cent, is the present value of an *ordinary* annuity, while the annuity in question is an annuity *due*. That is, \$14.21 is the present value of an annuity the rents of which are payable at the end of each period, while in this case the rents are payable at the beginning of each period, since it is assumed that the equivalent cash sum is payable on the date when the first monthly instalment would have been due.

In the second place, the formula $12 \times 57.50 \times A_{20}$ is based on the assumption that twenty annual payments are to be made, each of which is 12×57.50, or \$690. The facts are that 240 monthly payments of \$57.50 each are to be made. The annual rate is therefore only nominal. The effective rate is $3\frac{1}{2}$ per cent divided by 12, or 7/24 per cent.

Therefore, instead of using A_{20} at $3\frac{1}{2}$ per cent, or 14.21, it will be necessary to use the present value of an annuity due of 240 rents at 7/24 per cent. The present value of an annuity due of 240 rents is computed by finding the present value of an ordinary annuity of 239 rents and adding 1 rent. This could be represented by $A_{239} + 1$, the rate being 7/24 per cent. The formula would be $57.50 \times A_{239} + 1$.

Question No. 10:

The $4\frac{3}{4}$ per cent Victory notes mature at par on May 20, 1923. If a purchaser buys at \$96.20 on May 20, 1920, calculate the approximate yield per cent.

Given:	$2\frac{3}{4}\%$	3%
$A_6 =$	5.4264	5.4172
$V^6 =$	.8498	.8375

Answer to Question No. 10:

The approximate rate can be computed by determining what the price would have been if the bond had been purchased at an effective rate of $2\frac{3}{4}\%$ per period of six months; also what the price would have been on a basis of 3% per period. The difference between these prices caused by an

increase of ¼% in the rate will serve as an approximate measure of the excess of the effective rate over 2¾% when the purchase was made at $96.20.

Price on basis of 2¾% per 6 months:

Effective rate on par	2.75
Nominal rate on par	2.375
Difference	.375
Multiply by present value of annuity at 2¾%	5.4624
Discount	2.0484
Par	100.00
Discount	2.05
Price	97.95

Price on a basis of 3% per 6 months:

Effective rate on par	3.00
Nominal rate on par	2.375
Difference	.625
Multiply by present value of annuity at 3%	5.4172
Discount	3.38575
Par	100.00
Discount	3.39
Price	96.61
At an effective rate of 2¾%, the price would be	97.95
At an effective rate of 3%, the price would be	96.61
An increase of ¼% reduces the price	1.34
Price on basis of 2¾% per period,	97.95
Price on unknown basis	96.20
Decrease in price	1.75

Now, if a decrease of $1.34 in the price is caused by an increase of ¼% in the rate, the decrease of $1.75 in the price is caused by an increase of approximately 1.75/1.34 of ¼%, or .3265%.

Then 2.75% + .3265% = 3.0765%, the approximate rate per period; and 6.153% is the approximate rate per annum.

Schedule of Amortization

Date	*Coupon*	*Effective income*	*Discount amortized*	*Value*
May 20, 1920	....	....	....	96.20
November 20, 1920	2.38	2.96	.58	96.78
May 20, 1921	2.37	2.98	.61	97.39
November 20, 1921	2.38	3.00	.62	98.01
May 20, 1922	2.37	3.02	.65	98.66
November 20, 1922	2.38	3.04	.66	99.32
May 20, 1923	2.37	3.06	.69	100.01
	14.25	18.06	3.81	

This schedule shows that the 3.0765% rate is an unusually close approximation.

Question No. 11:

A company is issuing $100,000 of 4% 20-year bonds, which it wishes to pay at maturity by means of a sinking fund, in which equal annual deposits are to be made. The board of directors wishes to assume that this fund will earn 5½% interest for the first five years, 5% for the next five years and 4% for the last ten years. What is the annual deposit required?

Given:	5½%	5%	4%
S_5	5.581	5.526	5.416
S_{10}	12.875	12,578	12.006
$(1 + i)^5$	1.307	1.276	1.217
$(1 + i)^{10}$	1.708	1.629	1.480

Answer to Question No. 11:

The problem states that the directors wish to assume that this fund will earn 5½% interest for the first five years, 5% for the next five years and 4% for the last ten years. It is doubtful whether the examiners intended this statement to be interpreted literally. The fund will not earn 5½% interest during the first five years unless the first deposit is made at the beginning of the first year. This is not customary, and besides it would require a re-computation of various present values stated in the problem, converting them from present values of ordinary annuities to present values of annuities due.

The problem will be solved first on the assumption that the deposits are made at the end of each year, in which case the fund will earn 5½% interest during the second, third, fourth and fifth years, 5% during the next five years, and 4% during the last ten years. It will then be solved on the basis of a literal interpretation of the statement of prospective interest earnings.

It is regrettable that the values stated in the problem are not carried to six decimal places; the three-place numbers are not exact enough to permit proving the correctness of the sinking fund contribution. In the solutions which follow, the first column shows the results obtained by using the three-place values stated in the problem; the second column shows the results obtained by using six-place values.

COMPUTATION ON ASSUMPTION THAT CONTRIBUTIONS TO THE FUND ARE MADE AT THE END OF EACH YEAR

	(3-place)	(6-place)
First five contributions:		
Amount at end of first five years..............	5.581	5.581091
Multiply by 1.05^5...........................	1.276	1.276281
Amount of first five contributions at end of 10th year	7.121356	7.123040
Multiply by 1.04^{10}..........................	1.480	1,480244
Amount of first five contributions at end of 20th year	10.539607	10.543837
Next five contributions:		
Amount at end of 10th year..................	5.526	5.525631
Multiply by 1.04^{10}..........................	1.480	1.480214
Amount of second five contributions at end of 20th year	8.17848	8.179282
Next ten contributions:		
Amount at end of 20th year..................	12.006	12.006107
Summary:		
First five contributions amount to.............	10.539607	10.543837
Next five contributions amount to.............	8.17848	8.179282
Next ten contributions amount to.............	12.006	12.006107
Total	30.724087	30.729226
Sinking fund contributions:		
100,000 ÷ 30.724087 = ...	$3,254.78	
100,000 ÷ 30.729226 = ...		$3,254.23

The following schedule of accumulation is prepared by way of proof, although the applicant is not required and would probably not have time to prepare it in the examination:

Accumulation of Fund

First year, contribution	$3,254.78	$3,254.23
Second year, interest at 5½%....................	179.01	178.98
Contribution	3,254.78	3,254.23
Total	$6,688.57	$6,687.44
Third year, interest at 5½%....................	367.87	367.81
Contribution	3,254.78	3,254.23
Total	$10,311.22	$10,309.48

Fourth year, interest at 5½%	567.12	567.02
Contribution	3,254.78	3,254.23
Total	$14,133.12	$14,130.73
Fifth year, interest at 5½%	777.32	777.19
Contribution	3,254.78	3,254.23
Total	$18,165.22	$18,162.15
Sixth year, interest at 5%	908.26	908.11
Contribution	3,254.78	3,254.23
Total	$22,328.26	$22,324.49
Seventh year, interest at 5%	1,116.41	1,116.22
Contribution	3,254.78	3,254.23
Total	$26,699.45	$26.694.94
Eighth year, interest at 5%	1,334.97	1,334.75
Contribution	3,254.78	3,254.23
Total	$31,289.20	$31,283.92
Ninth year, interest at 5%	1,564.46	1,564.20
Contribution	3,254.78	3,254.23
Total	$36,108.44	$36,102.35
Tenth year, interest at 5%	1,805.42	1,805.12
Contribution	1,254.78	3,254.23
Total	$41,168.64	$41,161.70
Eleventh year, interest at 4%	1,646.75	1,646.47
Contribution	3,254.78	3,254.23
Total	$46,070.17	$46,062.40
Twelfth year, interest at 4%	1,842.81	1,842.50
Contribution	3,254.78	3,254.23
Total	$51,167.76	$51,159.13
Thirteenth year, interest at 4%	2,046.71	2,046.37
Contribution	3,254.78	3,254.23
Total	$56,469.25	$56,459.73
Fourteenth year, interest at 4%	2,258.77	2,258.39
Contribution	3,254.78	3,254.23
Total	$61,982.80	$61,972.35

Fifteenth year, interest at 4%	2,479.31	2,478.89
Contribution	3,254.78	3,254.23
Total	$67,716.89	$67,705.47
Sixteenth year, interest at 4%	2,708.68	2,708.22
Contribution	3,254.78	3,254.23
Total	$73,680.35	$73,667.92
Seventeenth year, interest at 4%	2,947.21	2,946.72
Contribution	3,254.78	3,254.23
Total	$79,882.34	$79,868.87
Eighteenth year, interest at 4%	3,195.29	3,194.75
Contribution	3,254.78	3,254.23
Total	$86,332.41	$86,317.85
Nineteenth year, interest at 4%	3,453.30	3,452.71
Contribution	3,254.78	3,254.23
Total	$93,040.49	$93,024.79
Twentieth year, interest at 4%	3,721.62	3,720.99
Contribution	3,254.78	3,254.23
	$100,016.89	$100,000.01

COMPUTATION ON ASSUMPTION THAT CONTRIBUTIONS ARE MADE AT THE BEGINNING OF EACH YEAR

First five contributions:	(3-place)	(6-place)
Amount of ordinary annuity of 1 for 5 periods at 5½%	5.581	5.581091
Multiply by	1.055	1.055
Amount of annuity due of 1 for 5 periods at 5½%	5.887955	5.888051
Multiply by 1.05^5	1.276	1.276281
Amount of first five contributions at end of 10th year	7.513030	7.514808
Multiply by 1.04^{10}	1.48	1.480244
Amount of first five contributions at end of 20th year	11.119284	11.123750

Next five contributions:		
Amount of ordinary annuity of 1 for 5 periods at 5%	5.526	5.525631
Multiply by	1.05	1.05
Amount of annuity due of 1 for 5 periods at 5%	5.8023	5.801913
Multiply by 1.04^{10}	1.48	1.588247
Amount of second five contributions at end of 20th year	8.587404	8.588247
Next ten contributions:		
Amount of ordinary annuity of 1 for 10 periods at 4%	12.006	12.006107
Multiply by	1.04	1.04
Amount of annuity due of 1 for 10 periods at 4%	12.48624	12.486351
Summary:		
First five contributions amount to	11.119284	11.123750
Next five contributions amount to	8.587404	8.588247
Next ten contributions amount to	12.48624	12.486351
Total	32.192928	32.198348
Sinking fund contribution:		
100,000 ÷ 32.192928 =	$3,106.27	....
100.000 ÷ 32.198348 =	....	$3,105.75
First year contribution	$3,106.27	$3,105.75
Interest at 5½	170.84	170.82
Second year contribution	3,106.27	3,105.75
Total at interest second year	$6,383.38	$6,382.32
Interest at 5½%	351.09	351.03
Third year contribution	3,106.27	3,105.75
Total at interest third year	$3,106.27	$3,105.75
Interest at 5½%	541.24	541.15
Fourth year contribution	3,106.27	3,105.75
Total at interest fourth year	$13,488.25	$13,486.00
Interest at 5½%	741.85	741.73
Fifth year contribution	3,106.27	3,105.75
Total at interest fifth year	$17,336.37	$17,333.48

Interest at 5½%	953.50	953.34
Sixth year contribution	3,106.27	3,105.75
Total at interest sixth year	$21,396.14	$21,392.57
Interest at 5%	1,069.81	1,069.63
Seventh year contribution	3,106.27	3,105.75
Total at interest seventh year	$25,572.22	$25,567.95
Interest at 5%	1,278.61	1,278.40
Eighth year contribution	3,106.27	3,105.75
Total at interest eighth year	$29,957.10	$29,952.10
Interest at 5%	1,497.86	1,497.61
Ninth year contribution	3,106.27	3,105.75
Total at interest ninth year	$34,561.23	$34,555.46
Interest at 5%	1,728.06	1,727.77
Tenth year contribution	3,106.27	3,105.75
Total at interest tenth year	$39,395.56	$39,388.98
Interest at 5%	1,969.78	1,969.45
Eleventh year contribution	3,106.27	3,105.75
Total at interest eleventh year	$44,471.61	$44,464.18
Interest at 4%	1,778.86	1,778.57
Twelfth year contribution	3,106.27	3,105.75
Total at interest twelfth year	$49,356.74	$49,348.50
Interest at 4%	1,974.27	1,973.94
Thirteenth year contribution	3,106.27	3,105.75
Total at interest thirteenth year	$54.437.28	$54,428.19
Interest at 4%	2,177.49	2,177.13
Fourteenth year contribution	3,106.27	3,105.75
Total at interest fourteenth year	$59,721.04	$59,711.07
Interest at 4%	2,388.84	2,388.44
Fifteenth year contribution	3,106.27	3,105.75
Total at interest fifteenth year	$65.216.15	$65,205.26
Interest at 4%	2,608.65	2,608.21
Sixteenth year contribution	3,106.27	3,105.75
Total at interest sixteenth year	$70,931.07	$70,919.22
Interest at 4%	2,837.24	2,836.77
Seventeenth year contribution	3,106.27	3,105.75
Total at interest seventeenth year	$76,874.58	$76,861.74

Interest at 4%	3,074.98	3,074.47
Eighteenth year contribution	3,106.27	3,105.75
Total at interest eighteenth year	$83,055.83	$83,041.96
Interest at 4%	3,322.23	3,321.68
Nineteenth year contribution	3,106.27	3,105.75
Total at interest nineteenth year	89,484.33	$89,469.39
Interest at 4%	3,579.37	3,578.78
Twentieth year contribution	3,106.27	3,105.75
Total at interest twentieth year	$96,169.97	$96.153.92
Interest at 4%	3,846.80	3,846.16
Total	$100,016.77	$100,000.08

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE. PART II

Answer questions 1, 2, 3 and any three other questions.

Question No. 1:

From the following trial balance of the Sampson Company, December 31, 1919, after closing, prepare a statement of financial condition, such as might be presented to bankers:

Debits		*Credits*	
Prepaid insurance $	1,850.00	Reserve for customers' discounts $	13,500.00
Plant property	350,000.00	Notes payable	35,000.00
Notes receivable	16,500.00	Surplus—capital	240,000.00
Finished goods	47,800.00	Profit and loss	243,650.00
Patents, trade-marks and goodwill	500,000.00	Reserve for credit losses	15,000.00
Prepaid interest	525.00	Accounts payable	62,000.00
Goods in process	53,750.00	Reserve for depreciation of plant property	85,000.00
Cash	52,425.00	Salaries and wages payable	2,350.00
Advances to salesmen	750.00	Preferred stock*	100,000.00
Materials and supplies	25,500.00	Common stock†	400,000.00
Treasury preferred stock	5,000.00	Dividends payable	2,000.00
Customers	145,900.00	Accrued taxes payable	1,500.00
Total debits	$1,200,000.00	Total credits	$1,200,000.00

* 1,000 shares, par value $100 each, preferred as to assets and dividends.
† 80,000 shares of no par value, issued at a stated value of at least $5.00 a share.

Answer to Question No. 1:

The following balance-sheet is patterned after the form recommended in the bulletin of the federal reserve board, *Approved Methods for the Preparation of Balance-sheet Statements:*

THE SAMPSON COMPANY

Balance-sheet, December 31, 1919

Assets

Current assets:				
Cash			$52,425.00	
Notes and accounts receivable:				
Notes receivable........		$16,500.00		
Customers		$145,900.00		
Total		$162,400.00		
Less reserve for credit losses	$15,000.00			
Reserve for customers' discounts	13,500.00	28,500.00	133,900.00	
Inventories:				
Materials and supplies..		$25,500.00		
Goods in process........		53,750.00		
Finished goods.........		47,800.00	127,050.00	
Total quick assets.........			$313,375.00	
Advances to salesmen.....			750.00	
Total current assets......			$314,125.00	
Fixed assets:				
Plant property............			$350,000.00	
Less reserve for depreciation			85,000.00	265,000.00
Deferred charges:				
Prepaid insurance.........			$1,850.00	
Prepaid interest..........			525.00	2,375.00
Total assets				$581,500.00

Liabilities

Current liabilities:		
Notes payable............	$35,000.00	
Accounts payable.........	62,000.00	
Salaries and wages payable	2,350.00	
Accrued taxes payable....	1,500.00	
Dividends payable........	2,000.00	
Total current liabilities....		$102,850.00

Net worth:

Preferred stock...........	$100,000.00			
Less treasury stock preferred	5,000.00	$95,000.00		
Common stock, no par value, 80,000 shares......		400,000.00		
Surplus—capital (probably excess of selling price of common stock over $5.00 per share).............		240,000.00		
Surplus—profit and loss...		243,650.00	978,650.00	
Less patents, trade-marks and goodwill...........			500,000.00	478,650.00
Total				$581,500.00

The bank is not interested in the preference rights of the preferred stockholders, as the bank's rights on a loan would be prior to the rights of preferred stockholders.

Question No. 2:

The A. B. C. university presents a balance-sheet at December 31, 1919, drawn up as follows:

Assets

General fund:			
Cash—general fund...........			$ 4,395.63
Unpaid tuitions			2,348.42
Accrued interest receivable......			5,764.08
Unexpired insurance			1,587.96
Furniture and equipment.......			59,853.18
Total general fund assets...			$73,949.28
Endowment funds:			
Bonds and mortgages..........		$336,750.00	
Stocks and bonds..............		75,312.62	
Real estate investments.........		163,149.30	
Real estate—university property.		135,641.68	
Cash—endowment funds:			
In banks	$10,800.91		
Due from general fund.........	14,358.32	25,159.23	
Total endowment fund assets.			736,012.83
Total assets...............			$809,962.11

Liabilities

Notes payable	$ 10,000.00
Accounts payable	8,724.59
Due to endowment funds	14,358.32
Total liabilities	$ 33,082.91
Endowment funds	736,012.83
General fund	40,866.37
	$809,962.11

You are asked to make an audit of the books, in the course of which you discover the following facts:

(a) The endowment funds are restricted as to the use of the income therefrom for general purposes of the university.

(b) The item "real estate—university property" represents amount paid in acquiring title to property upon which university buildings stand, which was originally leased by the university. These payments were made from the proceeds of sale of endowment fund investments. On December 29, 1919, the property upon which university buildings stand was sold and title passed for a consideration of $500,000.00, the cheque for which was not deposited until January 5, 1920.

(c) Cash shown as due from general fund represents endowment fund cash advanced to pay off obligations incurred as a result of university operations.

You are asked to criticize the balance-sheet as submitted, prepare necessary journal entries to set up the sale of real estate and prepare corrected balance-sheet of December 31, 1919.

Answer to Question No. 2:

The "real estate, university property," carried at $135,641.68, has been sold for $500,000.00, realizing a profit of $364,358.32. The question arises whether this gain belongs to income or to the principal of the endowment fund. On page 106 of Loring's *A Trustee's Handbook,* this statement is made: "The general rule is that any gain other than the usual yearly income and any loss other than the usual yearly charges fall to the principal of the fund." This being the case, the entry for the sale of this real estate would be:

Cash—endowment funds	$500,000.00	
Real estate—university property		$135,641.68
Endowment funds		364,358.32

To record sale of real estate, profit being added to principal of fund.

The balance-sheet as submitted is subject to the following criticism:

The total current assets and current liabilities of the general fund are not shown, and this is important, as the current assets, including the accrued interest, total only $14,096.10, against which there are current liabilities to outsiders totaling $18,724.59, in addition to the amount due to the endowment fund for advances.

The $14,358.32 due from general fund to endowment funds should not be shown as cash.

It is preferable to prepare the balance-sheet in two sections, as the en-

dowments are a trust which should be shown clearly as distinct from the general university funds.

As funds are assets, the appearance of fund accounts on the liability side of the balance-sheet is a violation of strict accounting terminology, but it is perhaps justified by custom in municipal and institutional accounts.

THE A B C UNIVERSITY

General Fund Balance-sheet, December 31, 1919

Assets			*Liabilities*		
Current assets:			*Current liabilities:*		
Cash	$4,395.63		Notes payable..	$10,000.00	
Unpaid tuitions.	2,348.43		Acc'ts payable..	8,724.59	
Accrued int. received	5,764.08		Total outside liabilities		$18,724.59
Unexpired ins..	1,587.96	14,096.10	Due to endowment funds..		14,358.32
			Total liabilities		$33,082.91
Fixed assets:			General fund:		
Furniture and equipment ...		59,853.18	Excess of assets over liabil'es..		40,866.37
		$73,949.28			$73,949.28

Endowment Funds Balance-Sheet, December 31, 1919

Assets			*Liabilities*	
Bonds & mortgages.		$ 336,750.00	Endow't funds.	$1,100,371.15
Stocks & bonds		75,312.62		
Real estate investments ...		163,149.30		
Cash:				
In banks....	$10,800.91			
On hand....	500,000.00	510,800.91		
Due from general fund for advances ...		14,358.32		
		$1,100,371.15		$1,100,371.15

Question No. 3:

The A B C company agreed to pay its general manager a bonus of 10% of its net profits for the year 1919, after deducting federal income and profits taxes, the bonus being a deductible expense in determining net taxable income. After the books had been audited it was found that the net profits before deducting federal income and profits taxes, and before

deducting bonus, amounted to $470,000, and that the invested capital for federal tax purposes for the year 1919 was $840,000.00. Calculate the amount of the bonus and federal income and profits taxes, proving your answer by showing that the bonus amounts to exactly 10% of the profits after deducting federal income and profits taxes. The entire bonus comes out of the 40% bracket.

Tax information:

Excess profits taxes exemption:

$3,000 and 8% of the invested capital.

Income-tax exemption:

$2,000 and amount of excess profits taxes.

Rates:

Excess profits taxes:

20% of the net profits in excess of the exemption and not in excess of 20% of the invested capital.

40% of the balance of profits.

Income tax:

10% of profit less exemption.

Tax before bonus, $173,124.

Answer to Question No. 3:

In order to determine what effect the bonus has on the tax it is advisable to compute the tax, step by step, on the assumption that there is no bonus. Then, by expressing the bonus as x, the tax can be recomputed, showing in terms of x the effect of the bonus on each element of the tax. (See page 229).

The problem states clearly that the bonus is a deductible expense in determining the taxable income; it is also clear that the tax is to be deducted from $470,000 in determining the basis of the bonus. It is not so certain whether the bonus is itself to be considered an expense in arriving at the basis of the bonus. The bonus "amounts to exactly 10% of the profits after deducting federal income and profits taxes." Deducted from what? We have put this question to six public accountants. Three of them think the problem means the taxes are to be deducted from $470,000, the remainder being the basis of the 10% bonus. If this interpretation is the correct one, and we believe it is, the bonus is not an expense in arriving at the basis of the bonus. The other three think that the bonus is 10% of the profits after deducting the taxes from the net taxable income. If this is correct, both the bonus and the tax should be deducted from the $470,000 in determining the basis of the bonus. The problem will be solved on both assumptions.

Solution on Assumption that Bonus = 10% of ($470,000 — tax)

Since the true tax is $173,124 — .46x,

	TAX WITHOUT BONUS Net profit = $470,000.00			*TAX WITH BONUS (Bonus = x)* Net profit = $470,000 — x		
First bracket:						
20% of $840,000 (invested capital)		$ 168,000			$168,000	
Less exemptions:						
Specific	$ 3,000					
8% of $840,000.........	67,200	70,200			70,200	
20% of................		$97,800	$19,560		$97,800	$19,560
Second bracket:						
Net profit		470,000			470,000 — x	
Deduct		168,000			168,000	
40% of................		$302,000	120,800		$302,000 — x	120,800 — .40x
Income tax:						
Net profit..............		470,000			470,000 — x	
Less exemptions:						
Specific	$ 2,000			$ 2,000		
First bracket..........	19,560			19,560		
Second bracket.........	120,800			120,800 — .4x		
Total exemptions.......		142,360			142,360 — .4x	
Basis of income tax....		$327,640			$327,640 — .6x	
10% of above..........			32,764			32,764 — .06x
Total tax..........			$173,124			$173,124 — .46x

$$\text{the bonus, } x = \frac{\$470{,}000 - (\$173{,}124 - .46x)}{10}$$

$$10x = \$470{,}000 - (\$173{,}124 - .46x)$$
$$10x = \$470{,}000 - \$173{,}124 + .46x$$
$$9.54x = \$470{,}000 - \$173{,}124$$
$$9.54x = \$296{,}876$$
$$x = \$31{,}119.08, \text{ the bonus.}$$

Profit before deducting bonus and tax		$470,000.00	
Deduct bonus		31,119.08	
Net taxable income		$438,880.92	
Computation of tax:			
First bracket (as above).......			$19,560.00
Second bracket:			
Net profit		438,880.92	
Deduct 20% of 840,000.....		168,000.00	
40% of..................		$270,880.92	108,352.37
Total excess profits taxes.......			$127,912.37
Income tax: net profit..........		$438,880.92	
Deduct exemptions:			
Specific	$ 2,000.00		
Excess profits taxes...........	127,912.37	129,912.37	
10% of......................		$308,968.55	30,896.86
Total taxes			$158,809.23
Proof:			
Profit before deducting taxes and bonus			$470,000.00
Deduct taxes			158,809.23
Basis of bonus.................			$311,190.77
Bonus, 10% thereof (as above)..			$31,119.08

Solution on Assumption that Bonus = 10% *of* ($470,000 — *Bonus* — *Tax*)

Since the bonus is represented by x, and since the taxes are $173,124 — .46x,

$$\text{the bonus } x = \frac{\$470{,}000 - x - (\$173{,}124 - .46x)}{10}$$

$$
\begin{aligned}
10x &= \$470{,}000 - x - (\$173{,}124 - .46x) \\
11x &= \$470{,}000 - (\$173{,}124 - .46x) \\
11x &= \$470{,}000 - \$173{,}124 + .46x \\
10.54x &= \$470{,}000 - \$173{,}124 \\
10.54x &= \$296{,}876 \\
x &= \$28{,}166.60.
\end{aligned}
$$

Profit before deducting bonus and tax		$470,000.00	
Deduct bonus		28,166.60	
Net taxable income		$441,833.40	
Computation of tax:			
First bracket (as above)			$ 19,560.00
Second bracket:			
Net profit		441,833.40	
Deduct 20% of 840,000		168,000.00	
40% of		$273,833.40	109,533.36
Total excess profits taxes			$129,093.36
Income tax:			
Net profit		$441,833.40	
Deduct exemptions:			
Specific	$ 2,000.00		
Excess profits taxes	129,093.36	131,093.36	
10% of		$310,740.04	31,074.00
Total taxes			$160,167.36
Proof:			
Profit before deducting taxes and bonus			$470,000.00
Deduct bonus			28,166.60
Net taxable income			$441,833.40
Deduct taxes			160,167.36
Basis of bonus			$281,666.04
Bonus, 10% thereof (as above)			$28,166.60

The following solution has been submitted by J. H. Hellums, of Seattle, Washington:

Method of calculating federal taxes and bonus in cases where bonus is based on net profits after deducting federal taxes.

Given: A corporation with an invested capital of $840,000.00 makes a profit of $470,000.00 before calculating taxes and has an agreement with its manager to pay him 10% bonus on net profits after paying taxes. In this case the entire bonus comes out of the 40% bracket. Taxes before applying bonus amount to $173,124.00.

The change in taxes as result of allowing bonus would be as follows:

Decrease in excess profits tax	40% of bonus
Decrease in normal tax	10% " "
Total decrease	50% " "
Increase in normal tax as result of decreased credit account less excess profits paid, 10% of 40%, or	4% " "
Net decrease in tax	46% " "

As result of decrease in taxes there is more profit in which the manager would participate to extent of 10%, or 4.6% of the bonus.

Calculation of Bonus

Profits before taxes	$470,000.00
Taxes—before applying bonus	173,124.00
Balance	$296,876.00
10% bonus on above	$ 29,687.60
4.6% of $29,687.60 =	1,365.63
4.6% of 1,365.63 =	62.82
4.6% of 62.82 =	2.89
4.6% of 2.89 =	.13
Total bonus	$31,119.07

CALCULATION OF TAX

Profits $470,000.00 less $31,119.07 = $438,880.93

20% Bracket

20% of invested capital	$168,000.00	
Excess profits credit 8% of invested capital plus $3,000	70,200.00	
20% tax on balance	$97,800.00	$19,560.00

40% Bracket

Profit	$438,880.93	
20% on invested capital...........	168,000.00	
Balance taxable at 40%...........	$270,880.93	108,352.37
Total excess profits taxes......		$127,912.37

Normal Tax

Profit	438,880.93	
Credits:		
Excess profits taxes plus $2,000.00.	129,912.37	
Balance taxable at 10%............	$308,968.56	30,896.86
Total tax		$158,809.23

Proof

Profit before tax and bonus........	$470,000.00
Taxes	$158,809.23
Balance	$311,190.77
10% bonus to manager............	31,119.07

In case the bonus came out of the 20% bracket the decrease in taxes would be 28% and the additional bonus to manager would be 10% of that amount, or 2.8% of the bonus.

When the bonus comes out of the 40% bracket the amount of bonus before figuring taxes plus 4.8217813% of itself will give the final bonus. If it comes out of 20% bracket use 2,880656%.

In case part of the bonus comes out of the 40% bracket and the balance out of 20% bracket, the calculation would be as follows:

A corporation with an invested capital of $100,000.00 makes a profit of $21,000.00, and has agreed to pay its manager 10% of net profits after calculating tax. The tax, before deducting bonus, would be $3,880.00.

CALCULATION OF BONUS

Profit before bonus and taxes....................	$21,000.00
Tax before deducting bonus.......................	3,880.00
Balance	$17,120.00
10% bonus on above..........................	1,712.00

Before deducting bonus there was a profit of $1,000.00 in the 40% bracket, but after deducting bonus the entire tax would fall in the 20% bracket. The

reduction in taxes as result of allowing the tentative bonus of $1,712.00 would be as follows:

46% of $1,000.00 in 40% bracket	$ 460.00
28% of $712.00 in 20% bracket	199.36
Total saving in taxes on first calculation of bonus	$ 659.36
Manager gets 10% of this amount	65.94
2.8% of $65.94	1.85
2.8% of $1.85	.05
Total additional bonus	$ 67.84
Tentative bonus	1,712.00
Total bonus	$1,779.84

The proof works out as illustrated in the first example.

Massachusetts C. P. A. Examination

Editor, Students' Department:

Sir:—Can you inform me as to qualifications requisite to taking C. P. A. examination in Massachusetts? Also when and where held?

Yours truly,
C. F. J.

Information in regard to the Massachusetts C. P. A. examinations may be obtained from the secretary of the Massachusetts state board of accountancy, Daniel B. Lewis, 45 Milk street, Boston, Massachusetts.

Book Reviews

LANGUAGE FOR MEN OF AFFAIRS: VOL. I, TALKING BUSINESS, by JOHN MANTLE CLAPP; VOL. II, BUSINESS WRITING, by JAMES MELVIN LEE. *The Ronald Press Company*, New York.

Quoting from the introductory chapter, vol. I, p. xi:

The purpose of the volumes of this set is to treat the general subject of language with reference to the needs and wishes of the business man. The subject falls naturally into two divisions:

1. Elementary phases of language, those which come into most constant use, either alone or combined in the more elaborate forms.

2. Specialized phases of language which are particularly featured in business; such as business correspondence, report writing, advertising copy, etc.

Or in other words into—
1. Talking business.
2. Business writing.

This excerpt not only gives in a nutshell the general aim of the volumes but is also a fairly good example of the art of converting literary—we had almost said Johnsonian—periods into concise business diction. In short, the set is intended to teach the business man how to speak and write correct English. In fact, it goes even further and devotes considerable space to the psychology of business talking and writing, i. e., how speech and writing may be used to sell goods. Also there are chapters devoted to public speaking by business men, on writing reports, advertising copy and circulars and on writing for the press. There have been many books written on these subjects, but this is the first work we have seen which aims to cover the whole field in a comprehensive manner, excluding, of course, the purely literary field.

Is there any need for such a work? Surely if a man has learned to speak and write English clearly and grammatically at school and college, it is enough. Thereafter the development of facility and ease in expressing himself depends entirely on his chosen career. As a writer he will naturally acquire a larger vocabulary of a literary type; as a lawyer, of a precise and argumentative type; as an engineer, of a technical, and as a business man, of a commercial type. In any walk of life the fundamentals of the language are the same. Whether the author is trying to write a story in a convincing and entertaining way, the lawyer to persuade a judge or jury of the justice of his cause, the engineer to prove a theory, or the business man to sell something—all must use the accepted grammatical forms and correct and appropriate words to convey their ideas and accomplish their purposes. In other words, says the doubter, there is no such thing as a distinct *language* for different professions and occupations. There is a common language, English, for all.

What we for convenience carelessly call technical language is merely the addition of words peculiar to a given profession or business, i. e., its vocabulary, but it is not a different language as would be French, Greek, etc.

This is all quite true; but, after all, the quarrel is rather with the title of the books than their matter. In every field of human life the language of daily intercourse and formal communication tends to settle into forms which will convey ideas in the quickest manner. When the judge says to the lawyers, "Submit your briefs," the banker to the borrower, "Give me a statement," the capitalist to the engineer, "Let me have a report," they all mean the same thing, viz.: "Let me know the facts." Even slang of the street, "What's the dope?" is simply a form in the making not yet accepted as good usage. In all these instances it will be observed that the language is English and correctly used, yet it is quite conceivable that the expression used by the judge might require translation if addressed to the borrower or engineer.

Granting all this, says the doubter, why a book on *business* English? No such books, at least none of any moment if you exclude "Every-man-his-own-lawyer" and the like, seem to be needed for the professions. The answer to this is two-fold. First, it is unfortunately true that the average business man has not had the education in fundamental English that nearly all professional men are practically obliged to acquire. Second, business in the larger sense of the term covers a much wider field than all the professions combined, and it is a matter of life and death to the business man that he shall make himself understood by thousands where the professional man is concerned with hundreds. By "understood" we mean not only the ability to make himself clear to those within the limited circle of his particular trade with the aid of its technical vocabulary, but also to convey pleasing and persuasive ideas to the general public—in short, to "sell them."

Hence these books. It should be understood, however, that they are not text-books in the ordinary sense though highly educational beyond all doubt. As is well stated by Mr. Clapp (vol. I, p. ix):

> The language of business is a matter for adult study. It has to do with adult conditions and relationships. It cannot be adequately treated in the lower schools. * * *
>
> It should be added, besides, that the technique of language cannot be learned once for all even by the adult.

It is rather difficult to classify the books in a phrase, but it is fairly safe to say that they combine a fascinating study of the philosophy and psychology of the English language as applied to business purposes with a well arranged guide to the best usage and style in business English from the informal selling-talk of the counter salesman to the public speech of the industrial magnate—from the letter of casual information to the highly technical and involved corporation report. Nor need it afflict the stickler for "Englyshe pure and undefyled" that advertising English seems to be the grand climax of both volumes. In these days of "jazz," when even "jazz" English is beginning to appear in some detestable and noisy advertising, it is a relief to

see in the chapters on advertising copy that its English need be neither silly nor vulgar.

Though there is but slight and casual reference to public accountancy in these books, nevertheless they will prove profitable reading to us who are so often called upon to write reports. We are indeed curious to know just what the author means by his reference to THE JOURNAL OF ACCOUNTANCY (p. 178), but hope that if we do have "the defects of such publications" we at least have the virtues!

Both volumes are well indexed, and vol. II contains two appendices giving bibliographies for both volumes—a valuable feature for those wishing to study further the subjects covered.

W. H. L.

ENGLISH OF COMMERCE, by JOHN B. OPDYCKE. *Charles Scribner's Sons Company,* New York.

It seems curious that this book which disclaims any pretension to teach "literary" English should be sent by its publishers to "the literary editor" for his supposedly expert opinion on it. Assuming that THE JOURNAL OF ACCOUNTANCY had a literary editor in the usual sense of that term, he might well dismiss Mr. Opdycke's book offhand, with the remark that a writer who lists such words as "lie" and "lay," "affect" and "effect," "statue" and "statute," as synonyms (see p. 12 et seq.), can hardly be accepted as an authority on literary English—or business English for that matter. We all make slips now and then, but this is surely inexcusable in a book intended to teach English.

The first four chapters are devoted to the implied purpose of the book, viz.: to teach high school and commercial students how to talk and write business English. Properly handled by the teacher they should furnish good drill-work for the student, but whether or not the matter therein is properly arranged according to the pedagogical mind we must leave to those versed in that science. Assuming that it is correct in form and substance, however, one's instinctive comment is, "Why the rest of the book?" For, after reading the remaining three hundred odd pages, one lays the book down with the feeling of having taken a short course in the psychology of advertising, and with more than a suspicion that much real advertising has been insidiously thrust upon his attention. Three "reference chapters" contain much information on abbreviations, special terms, business forms, etc., which should be useful to the business clerk, but we doubt their practical utility in a high school course.

Summing up, we should say if the book is intended for a high school text it is about two-thirds too long. As a handy book of samples for the advertisement writer it should be convenient and useful. The average business man will probably never find the time to read it through.

To us the most interesting part of the book is the introduction written by Frank A. Vanderlip. High school teachers, smarting under persistent

and more or less conventional complaints by business men that they fail to teach their pupils "how to write plain English," will relish Mr. Vanderlip's rather illuminating remarks on p. xiii:

"I should not, myself, put as great emphasis as has the author of this book upon the value of knowing words. * * * I should always put the primary emphasis on the value of clean-cut ideas. If one thinks clearly he is apt to write clearly."

Again, on p. xiv:

"What one must have, if he is going to make a success in a type of business where letter writing is an essential part, is an ability to think clearly and to write clearly."

Just so, and Mr. Vanderlip is no mean exponent of the ability and the art. In this particular instance he has voiced our own suspicion of several years' growth that what business men really complain about is not so much poor training in English composition as lack of original ideas and logical reasoning powers in high school graduates. Our own experience in passing on hundreds of examination papers has convinced us that inability to express his ideas intelligibly is quite rare on the part of the high school graduate, though he is sometimes without much of an idea to express. Something can be done to develop latent powers of reasoning by a severe course of logic, but this belongs to the domain of higher education in the universities. It is obviously unfair to damn the whole race of high school teachers of English composition because in the press of an over-crowded curriculum they fail to turn out boys and girls still in the teens filled with bright and original ideas. It is enough if their pupils are able to express what ideas they have in plain English. For the rest heredity and environment have much to do with the final results.

W. H. L.

Pennsylvania Institute of Certified Public Accountants

At the annual meeting of the Pennsylvania Institute of Certified Public Accountants, the following officers and directors were elected: president, William J. Wilson; vice-president, Horace P. Griffith; secretary, Robert J. Bennett; treasurer, Charles S. Rockey; members of council, Herbert G. Stockwell, Joseph M. Pugh, George Wilkinson, James J. Burns and John R. Lynn.

Oregon State Society of Certified Public Accountants

At the annual meeting of the Oregon State Society of Certified Public Accountants, June 14, 1920, the following officers were elected: president, Joseph Gillingham; vice-president, A. Lester Andrus; secretary and treasurer, A. R. Sawtell; directors: Arthur Berridge, T. A. Rutherford, L. M. Koon and W. J. Piepenbrink.

Certified Accountants' Association of Mississippi

The formation of the Certified Accountants' Association of Mississippi is announced. The officers are W. Q. Sharp, president; R. G. Wooten, vice-president; H. H. Cleaver, secretary.

Setchell & Luther, Old Smith building, Boston, Massachusetts, announce the dissolution of partnership by mutual consent. Morton E. Setchell announces that he will continue practice under his individual name.

R. B. Benedict, J. W. Quilty and E. W. Van Meter announce the formation of a partnership for the practice of accounting, under the firm name of Benedict, Quilty & Van Meter, with offices in Insurance building, Oklahoma City, Oklahoma.

Mitchell, Castenholz & Co., announce the dissolution of partnership. J. J. Mitchell retains the New York office of the firm at 103 Park Avenue and announces the opening of an office at 79 West Monroe Street, Chicago, under the name of J. J. Mitchell & Co. W. B. Castenholz retains the Chicago office of the firm and will practise under the name of William Castenholz & Co., with offices in Chicago, New Orleans, Kansas City and Tulsa.

Waldman & Schoolman announce the admission of Joseph F. Loewi into special partnership, the change of the firm name to Waldman, Schoolman & Co., and removal of offices to 507 Fifth avenue, New York.

J. Edward Moore and Charles P. Sawyer announce the formation of a partnership under the firm name of Moore & Sawyer, with offices at 545 Pleasant street, New Bedford, Massachusetts.

Barrow, Wade, Guthrie & Co., New York, announce the opening of a branch office in Clarendon building, 219 Genesee street, Utica, New York, under the management of Harry Brick.

Lovejoy, Mather, Hough & Stagg, members of the American Institute of Accountants, announce the removal of their offices from 55 Liberty street to 123 Liberty street, New York.

David Berdon announces the formation of a partnership with Joseph Sandler, under the firm name of David Berdon & Co., with offices at 277 Broadway, New York.

Harvey S. Chase & Co. announce that Charles C. Tuttle, William J. McAvoy, Richard D. Seamans and Arthur P. Batchelder have been admitted to the firm.

The Kinney Audit & System Company, of Dallas, Texas, announces change of the firm name to Kinney & Fowler, with offices at 417 Slaughter building, Dallas.

Ward, Fisher, Carpenter & Philbrick announce that William H. Segur, Clarence Watson Scott and Ernest L. Goodman have become partners of the firm.

A. H. Berger and Julius W. Baer announce the formation of a partnership under the firm name of Berger & Baer, with offices at 277 Broadway, New York.

McLaren, Goode & Co. announce the removal of their Salt Lake City offices to 203-204 Continental National Bank building.

Stockwell, Wilson & Linvill, Land Title building, Philadelphia, announce that John C. Parry has been admitted to the firm.

J. F. Stutz and F. H. Jones announce the formation of a partnership, with offices in Jenks block, Port Huron, Michigan.

Eli Moorhouse & Co. announce the removal of their offices to 706 L. C. Smith building, Seattle, Washington.

Richard S. Wyler & Co. announce the opening of offices in Scarritt building, Kansas City, Missouri.

Edward R. Burt & Co. announce the removal of their New Orleans office to 807 Maison Blanche building.

Henry F. Tully announces the opening of an office at 614 Penobscot building, Detroit, Michigan.

Waud & Doherty announce the removal of their office to 25 West Forty-third street, New York.

O. A. Grundmann announces the removal of his office to 225 Fifth avenue, New York.

Bennett & Berck announce that they have opened offices at 27 William street, New York.

Mackay, Irons & Co. announce the removal of their offices to 29 Broadway, New York.

Horwarth & Horwarth announce the opening of an office at 115 Court street, Boston.

Samuel Kraft announces the removal of his office to 1123 Broadway, New York.

George Illmensee announces the opening of an office at 74 Broadway, New York.

The Journal of Accountancy

Official Organ of the American Institute of Accountants

Vol. 30 OCTOBER, 1920 No. 4

Report of the President*

By Waldron H. Rand

We have arrived at another year's close in the life of our institute. Another retrospect is in order. Another outlook into the future invites us.

It is the occasion for change in officers and guiding minds. There is a limitation of a two years' term for our president, and our executive committee and the standing committees at this time are subjects for reorganization.

Preferment in the institute by election to these offices is a thing to be highly esteemed. They constitute positions of highest honor in the profession. Membership in the executive committee may be compared to a government cabinet position—at least, as we used to consider the cabinet position—where council is taken together before the determination of action. Many responsibilities are placed upon this committee by the constitution and bylaws. Its duties include strict observance of attendance at meetings and of familiarity with a multitude of business matters, upon the right settlement and prosecution of which the success of our institute largely depends. We cannot ask any better or more faithful and intelligent service than has been rendered by the executive committee during the administration now closing.

The reports of the executive committee, the board of examiners, the treasurer, the secretary and various standing committees form, as usual, references which every member of the institute should carefully read.

We are a going concern, and we are headed in the right direction. During the past year our membership has been increased

* Presented at the annual meeting of the American Institute of Accountants, Washington, D. C., September 21, 1920.

by 56 members and 62 associates. In addition to the work incident to this increased membership, including the preparation of examination papers and the conduct of oral examinations, our board of examiners has examined the written papers of 1,101 candidates for the C. P. A. registration. The various states seem to like what they are pleased to call a standard examination. But we must be careful to make our standard reasonable and not to place the requirement so high as to create a demand for knowledge superior to what might be expected of a candidate possessing but four years' public practice.

There is one interesting thought involved among many in this examination of candidates for practice as public accountants. As now regulated the technical examination required is rather easy for those otherwise eligible for admission to the institute, while it is rather difficult for candidates for registration as certified public accountants.

About 20 per cent to 40 per cent of the latter group of candidates are successful in passing, while there are about 70 per cent of the former group who succeed.

A principal reason for this is that the problems in practical accounting are mostly taken from the actual practice of public accountants. And candidates who have had the longer experience as public accountants have less difficulty in understanding a problem and applying right principles to its analysis and solution.

While the increase in cost has been great during the year just closing compared with the fiscal year ended September, 1919, we are able proudly to refer to an increase in our financial net worth and an increase in our net income for the same period. The committee on budget and finance has prepared a budget for next year totalling disbursements of about $47,000.

Our review of the past year would be lacking an important essential of progress were we to omit reference to The Journal of Accountancy, the circulation of which has increased from 12,000 in 1919 to approximately 14,000 paid subscriptions. Credit for this success is due to several causes, prominent among which has been the capable editorship by our secretary, the wise supervision of the committee on publication and the practice advocated by many of our instructors in accounting of subscriptions by undergraduates in our schools of commerce.

We heartily commend the bulletin, issued to members by the secretary, as a powerful agency for united thought and effort. The bulletin is a confidential, monthly summary of news concerning the activities of the institute and other matters affecting the accountancy profession at large. It has steadily grown in favor since its first number was printed in December, 1916. The librarian's circulars also are to be praised, and your attention is particularly invited to Mr. May's report on administration of endowment, which evidences so prominently the great and increasing benefit to our members of this wise provision for their help.

We have taken a long step forward for the perpetuity of the institute in the acquisition of a permanent home in New York. This will permit opportunity for the growth of our statistical library and the work of our librarians, will supply much needed room for the clerical force required by the secretary, and for the added labor connected with our publication of THE JOURNAL, and furnish an accessible office for out-of-town members visiting New York.

The professional public accountant has experienced a prosperous year. Many have returned to practice who have been serving government in war-time. The soldier's uniform has been laid aside and in most cases the accountant has shown himself abler and wiser for his war experience. The business man to a greater extent than ever has demanded the services of an experienced guide for the keeping and closing of his accounts and multitudes have had to call for help in the preparation of tax returns.

Considerable work has been done to further one of the prime objects of our organization. I refer to the first object as read in our constitution, "to unite the accountancy profession of the United States."

Regional meetings have been advocated as one line of effort for the accomplishment of this purpose. Members who are located at a great distance are frequently prevented thereby from attending conventions of the institute. It is expected that regional meetings will admit of partly overcoming this disadvantage and largely make for the prosecution of the common aim for unity.

Chapter organizations also have been seriously considered and are expected some time to become an achieved reality, at least in some states where now there exists no state society.

Contra to our many increases and visible growth we are met

by the inevitable loss by death among our members. Their work here is ended and they present to the Great Judge a balance-sheet to exhibit their net worth. Their true value may be unknown to us, and we seem to see only the assets of their report. We inherit some of these as reflected in their past connection with our profession, and, like true goodwill, their past association with us should and will continue an encouraging incentive to right effort on our part and to greater appreciation of our profession on the part of the public.

We are looking toward the future with feelings of strong faith in the men of our profession. Some of us are growing old and feel the weight of declining years, while our hearts still beat exultantly over the prospects ahead. Our young men will take up the work in our stead and will bring renewed vigor and increased talents into action. May we speak a word of caution? It is this: "Do not, by thought, word or deed, commercialize this profession of accountancy." The new practitioner must not expect to build a practice except by slow stages. He may secure a partnership in some established firm. He may be greatly helped by recommendations of fellow accountants, but his new client will come chiefly because an old client has been faithfully and ably served. His increased earnings will come from increased merit. The faithful physician does not measure his success by the size of his bill nor does he depend upon a contingent fee. To heal the sick and relieve the suffering is his goal. The bill is secondary. This theory may seem visionary, even delusive, to some, when applied to the practice of the public accountant. But the most important part of our work is not the preparation and collection of our bills for services, but the healing of the business sick and the relief of the business suffering, and, it may well be added, the prevention of both business sickness and suffering. A reputation of ability to cure and to prevent will prove a better advertisement than all others combined.

WALDRON H. RAND.

Supervising the Work of the Accounting Staff *

By John R. Wildman

The accounting staff may mean any number of men from one to four hundred and fifty. Its function is to perform the field work, gather the necessary data for and in some cases prepare professional reports, embracing a number of types and covering a variety of subjects.

Supervision varies as the staff increases in number and distribution and the engagements vary in diversity and complexity. It is a simple matter to oversee the work of five men engaged in making regular audits. It is a somewhat complex matter where there are from four to five hundred men distributed over twenty-five offices and handling engagements which embrace defalcations, estate accounting, public utility investigations, tax revisions and audits of industrials, comprising in some cases perhaps as many as one hundred and fifty companies.

The accounting staff is derived from many sources. There is the man who, anxious to make his career in accountancy, comes recommended by a mutual friend. There are those who come from schools, the aim of which is to prepare men for the profession. Bookkeepers, clerks, statisticians and representatives of sundry other vocations find their way by devious routes to the average staff. Some are well educated and prepared. Others have much to learn. So it is that the personnel plays an important part in the problem of supervision.

The ideal staff is one comprised of men of fine character, pleasing personality, keen mentality, good general education, high technical ability, supplemented by experience in meeting the problems which arise in responding to the needs of clients. If the real were to coincide with the ideal there would be little to supervision but the marshalling of forces and the handing out of engagement memoranda.

But supervision goes further back than assigning men to engagements. It begins with the selection of the men for employ-

* A paper presented at the annual meeting of the American Institute of Accountants, at Washington, D. C., September 21, 1920.

ment. It examines into their past, investigates their references, tests their mental and technical ability, considers their personality and their probability of development.

The practice of accountancy involves not only the man on the staff; it involves consideration of the client, the engagement, conditions, relations. Clients may be as varied as the varieties of the human race. Engagements may follow perhaps ten different types but the conditions and relations attending them may be manifold. All these matters have their bearing on supervision.

The staff, from a point of view of composition, should be well balanced. The ability to handle what may be regarded as general engagements should be supplemented by ability to take care of special work. Thus either the men who look after the regular audits must be able to do brokerage, trust company, cost work, etc., or provision must be made to carry men who are specialists in these lines. As to the latter, a jack of all trades may be in traditional disrepute, but the man on an accounting staff who is master of several special lines as well as a good general accountant reduces greatly the worries of the man who is responsible for the composition of the staff. Specialists too often result in an excess of unemployed time if the special engagements decline in number and the specialist is not able to turn his hand to general work.

The requirements of engagements call generally for a division of accountants on the staff into two classes. One class is made up of those who take charge of engagements, referred to by some firms as in-charge accountants; by others, as seniors. The second class is that great body comprised of individuals known as assistants. Perhaps every nine out of ten engagements call for such classification. Every now and then, however, an engagement appears which requires a further division of the latter class. Such are the cases where the volume of detail work requires a number of assistants with some one, acting as an aid to the man in charge, overseeing the work of the assistants. There is also the engagement, comparatively simple in character, in which a high grade assistant performs all the work connected with the engagement including the preparation of the report. In such an engagement he takes pride in the fact that he is entrusted with the work and is classified for the time being with those who take charge of engagements.

Thus is a third class introduced, which is somewhat difficult to describe. The man who falls into this class may be engaged, one day, as first assistant on a large or fair sized engagement; the next, on one by himself. Such accountants have been referred to both as semi-seniors and as senior assistants. But regardless of the names by which they are known it appears that supervision must take cognizance of at least three classes, possibly more.

It is presumed that the public accountant who is retained by a client to undertake an engagement will make every effort to serve the client faithfully and well. If for one reason or another it is necessary or desirable to delegate the work of carrying out the engagement in whole or in part to representatives, the presumption follows that the accountant will so regulate and keep in touch with the work of such representatives as to satisfy himself that the work has been carried out in accordance with his ideas, to the end that for purposes of relations with clients he may adopt the work as his own. It therefore devolves upon the accountant to devise some means of bringing this about. It is this, taking into consideration all the factors involved, which is expressed in the term supervision.

Satisfactory service to clients depends obviously on finding out what the client wants. Many a client has been forced, so to speak, to take and to pay for something which he neither ordered nor wanted. In many cases such miscarriages of service have been due to failure on the part of the person who took the engagement to find out definitely what the client desired, or, where the client was not entirely clear, to study the situation, squarely from the client's point of view and advise him as to his needs. Too many engagements are taken and performed in a perfunctory manner without regard to the point of view of the client, his relations and needs.

With this point covered, supervision must needs take into consideration the accountants on the staff in connection with their work in the field and in the preparation of the report.

It is to be expected that the accountant to whom the engagement is assigned will receive a memorandum of some sort, setting forth not only the essential requirements connected with the engagement but any special information which will throw light on the situation or assist in any way in carrying it out to the satis-

faction of the client. Many times the person who takes the engagement gleans bits of valuable information from conference with the client, and this information should be passed on to the accountant who is to undertake the work. One client, for example, mentioned casually during a conference that he wished but one copy of the report. The remark fell on deaf cars. The client was much annoyed when later he received three copies.

It is also helpful if the person who took the engagement has an opportunity to go over the case with the accountant assigned before the latter takes up the work. Many minor points, which may not be embodied in the engagement memorandum, are thus passed on and contribute to the successful execution of the engagement.

Once in the field the accountant in charge is expected to lay out his work, assign his men and busy himself with the more important phases of the engagement. As to the proper performance of the work assigned he may either inspect it himself or delegate such function to his chief assistant.

It should be pointed out that the part of supervision which consists of inspection of work done by assistants should not be too long delayed. Frequently an assistant fails to understand his instructions and so unintentionally does unnecessary work or work which is wrong in principle. Again, men who are careless and who make mistakes creep into the corps of assistants. For such reasons it is important that all work performed by assistants should be inspected not only frequently but soon after it has been started.

The general progress of the engagment and the work of the accountant in charge should be reviewed in the field as often as the requirements of the engagement and the circumstances surrounding it indicate. On some engagements the work of the accountant in charge as well as that of the juniors needs inspection several times during its course. On others a general review of the situation just before the field work is completed is all that is required. Anything of this kind would probably be unsafe except in cases where men in charge of engagements are old and trusted accountants whose ability and reliability are known quantities.

Apropos of this point it may be said that some accounting firms have, in addition to the three classes of accountants pre-

viously mentioned, a fourth class comprised of men of unusual ability and long service known as supervising accountants. It is the function of accountants in this class to spread themselves over several engagements, apportioning their time among the various engagements as needed. Such accountants do not to any great extent participate in the actual work but give their attention to the respective engagements to see that they proceed with utmost speed and efficiency.

Field supervision tends to reduce the time necessary to review a report and working papers. While the practice with regard to the preparation of reports differs in different organizations the reviewing of working papers probably is about the same in all cases. It consists in looking over the papers to see that the figures are tied up, that general and controlling figures are properly supported, that analyses set forth the necessary information, etc.

It is usual, also, in reviewing papers to quiz the accountant in charge of the work concerning it. This is based on the theory that a man who has properly carried out an engagement should be able to furnish any reasonable information about it. Further, if the person who reviews the papers is not able to ask the accountant a question which he cannot answer the chances are the client or his employees would not be able to do so.

In some public accounting organizations the reports are written by so-called principals, that is, members of the firm, or some one of equal authority. In other organizations the reports are written in the rough by the accountants in charge. Each method perhaps has certain advantages. The former probably tends more strongly to uniformity. The latter has in its favor the fact that more reports may be turned out in a given time. It also adds interest and responsibility to the accountant's work besides developing and broadening him.

Where the latter method prevails it becomes necessary for the reviewer, in addition to examining the papers and incidentally the accountant, to go carefully over the report. The statements must be reviewed for form and content. The comments must be read not only from a technical point of view but a literary point of view as well. Diction, paragraphing and punctuation are essential to clear expression. After all, the most brilliant and clever findings are of no avail unless so expressed that the layman can understand them.

The certificate and the presentation page must be perused for structure, usually to see that they are in keeping with some prescribed form. These parts of a report are generally worked out with care and standardized. Statements also may follow more or less after a set form. Comments, of course, must be made to fit the particular case, except that a certain order or arrangement of topics may be laid down.

Standardization is much to be desired, particularly where a number of different accountants are preparing complete reports. It is possible to a certain extent but may not be carried safely beyond a certain point without resulting in a report which is stilted and sometimes meaningless. For example, an accountant on the staff of a certain firm was told that the report for a given corporation, the officers of which were very particular, once having been prepared by a member of the firm, was not to be changed from year to year except as to figures. He accepted the remark and followed it literally to the extent of reproducing in a subsequent report the wording of the comments from the report of the previous year changing only the figures. The result was amusing. For example, increases in inventories in the previous year had worked around to decreases, so that it was impossible in reading the comments to reconcile the words with the figures. Fortunately the report, in this shape, went no further than the reviewer.

One of the most difficult things to achieve, of course, is that state wherein the staff accountants in charge of engagements write live, interesting reports. The man, where fixed standards prevail, is almost a genius who can conform to the many rules laid down, adapt the specifications for reports to the circumstances surrounding the particular case in hand and write a report with life enough in it to interest the client. Accountants' reports will become more valuable to clients, in the opinion of the writer, as they become more interpretative. What most clients want is not alone a statement of facts, but to be told how to use the facts as a basis for administrative or other action. Many accountants also have the idea with regard to reports that quantity not information is the prime essential.

Supervision in the field should go further than the technicalities of the engagement. It should include the scrutiny of the men, their personal appearance, their adherence to hours, attention to

work, relation to employees of the client and their general behavior. It should cover consideration of the probable time when the respective men will finish their work on certain engagements so that the office to which they are attached may be advised when they will be available. The rendering of time and expense reports should not escape attention.

Supervision is neither complete nor scientific which does not take into consideration the instruction and training of the men on the staff. They should be enlightened as to their duties and responsibilities when they join a given staff. They should be acquainted with some of the general facts relating to the organization. They should be obliged to study and improve their knowledge of subjects which they are required to use in their work. But they should also be instructed and trained in their work on the engagement. Nothing is so instructive as applied theory. The ideal place to apply theory is on the engagement. The work may not be interrupted for instruction but the instruction may be woven into the work. The accountant in charge should seize every opportunity to explain the work to his assistants. The supervising accountant should make it a point to teach in-charge accountants.

Supervision becomes more effective and less expensive as each man in the organization understands what he is to do and does it. Satisfaction to clients, under the present scheme of organization for rendering professional accounting service, is bound to become more general as the staff men become better trained and supervision becomes more scientific.

Growth and Effect of Branch Offices *

By F. A. Ross

Prior to a time which may be set at approximately twenty years ago public accounting was conducted in the United States by practitioners, either individually or in partnership, whose business was largely confined to one city and the territory adjacent to it. Engagements might sometimes require that accountants be sent to more remote points, but in the main the practitioners of that day enjoyed only a local practice. This condition has changed. To some extent during the first ten years of the twenty, and to a greater extent during the second ten-year period, accountants who had begun their practice in one city established branches, and to-day firms thus organized are represented in a number of different localities. I have been invited to address this, the annual meeting of the institute, on this scheme of organization. Without attempting to deal in detail with growth in individual cases or with particular effects, I propose to discuss the matter as one of policy.

In the preparation of this paper, I have had opportunity to consider a number of criticisms that have been made. They make a comprehensive list and seem to embody whatever objections could be urged. Some bear on the merits of the system; some relate only to individual acts which are justly criticized but do not constitute necessary faults in the form of organization itself. The only comment that will be offered at this point is that despite objections that prima facie appear to be substantial, the policy is sound and a necessary development in attaining effectiveness in the relation of public accounting to the business of the country.

In relation to the manner in which business generally is conducted to-day, it is a commonplace comment that conditions are widely different from those which prevailed a quarter century ago. It was the rule then that the proprietor was the active manager and that the scope of his business did not prevent his having intimate personal acquaintance with all phases of it. Its opera-

* A paper presented at the annual meeting of the American Institute of Accountants, at Washington, D. C., September 21, 1920.

tions came under his own eye. He was familiar with its routine and with the efficiency of his employees individually. Weaknesses of method or of performance came directly to his attention. On the financial side, his requirements for credit were met by his own banker. The credit he secured was based largely on acquaintanceship and the standing of his house as judged by the banker. The establishment of efficient credit departments in banks is distinctly a modern development. It may be noted in passing that what is here stated as the old-time basis of bank credit still prevails in certain sections of the country. There are doubtless accountants in this audience who could tell moving tales of the difficulties encountered in building up a practice because of that very fact.

I do not overlook that the conditions above described obtain to-day with regard to a very large volume of business, the country over. But it is equally true that they do not, for another very large volume. In the case of the latter, neither financing nor operation is local, and it is this change in conditions which makes the branch-office system in public accounting now necessary, in order that the demands of present-day business shall be adequately served.

I note first that the capital this business needs is obtained in large measure in the financial centers of the country—and not locally—from commercial banks and investment bankers. Almost universally the certificate of an accountant is required in connection with the transactions. And it is demanded that the signature to the certificate be that of accountants whose reputation is established with the lenders.

The capital thus sought from financial centers is required, broadly, for two purposes: the one for current working capital, for which short-term notes are given; the other for permanent capital, for which long-term securities are issued. In transactions of the first kind, the commercial banker or the notebroker is a party. Transactions of the second kind pass, as a rule, through the hands of investment bankers. It will be conceded by all accountants that the banker's requirement of the certificate of an accountant is in the interest of sound business and very directly in the interest of the accounting profession. It must be conceded, also, that by some means the qualifications and standing of the

accountant who certifies to the affairs of the borrower must be established to the satisfaction of the creditor. The branch-office policy meets that requirement effectively.

Fundamentally, the standing of an accountant is a matter of local reputation. If New York be cited as one of the financial centers where such service as has been described is called for, it may be said that the weight given there to the certificate of an accountant is based primarily upon the position he has achieved by his practice in that city. The acceptance of certificates issued by branch offices is a result of the confidence in standards and methods which has been inspired by work well done locally. The significance of the point is that at bottom the firm with a branch-office organization and the firm whose practice is confined to a restricted territory are in the same position, in that the acceptability of their certificates depends on the reputation enjoyed in the locality where the certificate is to be used. The firm which operates branches has simply made that local reputation serviceable for business of much broader scope.

The effectiveness of the branch-office system in connection with financing is not confined to the simple furnishing of a certificate. The banker often wishes to go behind that. Questions about items in the statement occur to him. The merchant or manufacturer who is seeking credit is in New York anxious to complete his arrangements and get away. Recourse is had to the New York office of the accountant, and the questions raised are settled in a few hours. Such occurrences are frequent and there cannot be any doubt that the prompt service rendered facilitates the transaction of the business between the parties.

Further, the firm which operates branches is in a position to give service in cases of permanent financing that could not be given in any other way. A case in point may be cited. A company engaged in the production of oil found it desirable to refinance. Its operations were in the southwestern field; its bankers in New York. As occurs not infrequently, the call upon the accountant was for prompt action. The principal work was done in the operating office, but close contact with the New York principals was necessary while the work was in progress. All these requirements were met promptly and satisfactorily, but that result was possible only because the New York office of the accountants had its own people in the territory where the company operated.

I present the foregoing with the conviction that it demonstrates that the firm which has branches does in fact render a valuable service. It is no exaggeration to say that it is a service vital to the convenient transaction of a large part of the general business of the country, as conducted in the day in which we live. If the fact of the service be granted, and the means by which it is accomplished are still decried, the critic of the means employed must present an effective alternative method. Such an alternative has been presented to me in the following words:

> There is no reason why firms in other cities having work to be done in any town or district should not call upon local practitioners to coöperate. This would increase the prestige of the local man and obviate the necessity for a branch office.

It may well be agreed by those who approve the branch-office policy that in specific cases, and to a limited extent, the results that are required could be attained under coöperation between the accountant of the client interested and fellow practitioners in other localities. But the qualification "to a limited extent" is used advisedly. Such coöperation could not suffice for more than a small proportion of the work done through the agency of the head office and the branches of a firm so organized.

Take the case of a firm established in New York, which conducts well distributed branches. To render in coöperation with local practitioners the service it can and in fact does render through its branch-office organization it would have to establish relations with twenty or thirty individuals or firms scattered throughout the country. It is not practicable for various reasons. Suppose this firm be called in by a client one afternoon to take up an engagement requiring work immediately at, say, five different points. It occurs often. The accountant, being well informed of conditions in his branches and in authority over them, can meet the requirements of the occasion at once. Could he have such arrangements with independent practitioners as would permit him to bind them to immediate performance in the same way? And the point is material, for the modern business man demands just such service. Again, let any accountant who advocates this method of doing widespread work consider whether he would choose to enter upon a course that would make him responsible for the time and expense charges of several colleagues. Could he reasonably

expect to handle that phase of the matter so that his client and his colleagues would be always content? And, again, being directly responsible to his client for performance as to time, would he be willing to depend for completion of the work within a time satisfactory on colleagues who then might not be in a position to meet the requirements in this respect?

These are points of detail, but satisfactory results from coöperation between independent practitioners would depend on avoidance of friction in a great many points of detail. As a practical matter there is little prospect that it could be accomplished.

But the principal reason why such coöperation is not practicable on an extended scale is not so tangible. Given accountancy work where there must be coöperation between the office of an accountant in, say, New York and accountants in one or more other parts of the country, it is essential to the best service that the coöperation be between men who are permanently associated. Even where there is equality with regard to knowledge of principles, standards of practice and breadth of experience, accountants who practise independently develop different methods and habits of thought. Those who are permanently associated come to the same way of looking at things. When it is necessary to work together they "speak the same language." And in a large volume of the work where a head office and branch offices are concerned this is essential to satisfactory performance. In special cases coöperation between independent practitioners may be practicable. In the day-to-day work of the firms we are considering a unity of thought and methods of work which can be obtained only by continuous association is required.

To this point emphasis has been laid on the ability of firms of accountants which conduct branches to render service in connection with financing. It is advantageous in other respects to firms and corporations which, like the accountants we are discussing, also operate through branches. In the modern development of business, this form of organization has come to be widely used, and for various reasons. Manufacturers have recourse to it for reasons connected with the supply of raw material and labor; jobbers, in the regular expansion of their business, for convenience of distribution, equalization of freight costs and like considerations. Where retailers are widely spread there is usually

something distinctive about their business. One specializes in one kind of merchandise; another builds up business on the basis of a uniform, moderate price for everything sold, and another establishes a large number of general merchandise stores and brings to the people of the communities served the benefits derived from buying on a large scale. But whatever be the reasons for the establishment of branches by business houses, it is a fact that it is a common form of business organization. It is something to be desired in the interests of accountancy as a whole that the proprietors of businesses so organized shall value and employ the services of accountants, whether for the installation of uniform systems, periodic audits or other work.

There are three possible methods under which work of this scope could be undertaken: by the coöperation between independent practitioners I have discussed, by the accountant who controls the business sending men from his one office, or through the branch-office scheme of organization. As to coöperation of colleagues I maintain that the arguments presented in relation to financing apply with even greater force where the object of the work is to serve the client in connection with other phases of his business. To me it seems self-evident that better results must be possible when the work at several points is directed by one head, with definite authority over all engaged upon it.

I have recognized that widespread work might possibly be handled from one central office but am not disposed to give serious consideration to it. It could be done, but all that could be accomplished by that means can be accomplished more quickly, more economically and more efficiently through branch offices. The accountant who undertakes such work can serve his client best by maintaining at well-selected points representatives who become familiar with people and conditions in their territories and are available for consultation and for information when questions arise, as they often do, after the immediate work has been accomplished.

A firm with branches well distributed includes in its organization representatives who in the course of practice acquire familiarity with enterprises peculiar to their localities and the distinctive characteristics which the accountant must know if he is to deal with them intelligently. Through the close intercourse which

prevails between those associated in these firms this specialized knowledge spreads throughout the organization; and clients in the principal centers thus have at their command a service which meets their needs and in the nature of the case the local practitioner cannot give.

Examples of industries wtih distinctive characteristics are:

Oil producing and refining—in Texas and Oklahoma.
Grain—in the territory between the Mississippi river and the mountains.
Copper mining and smelting—in the mountain states.
Shipping—in the seaboard towns.
Coal mining and steel manufacture—in distinct sections of the country.
Cotton mills—in the north and south Atlantic states.

It is conceivable that in this particular connection a local practitioner might feel that a field which he had made his own by long application is encroached upon unwarrantably. But looking to the welfare of the profession as a whole it must be granted that it is best fostered by the ability to respond promptly and efficiently to the demands of the business world. If only some particular form of organization makes the best service possible, it is to the interest of the profession at large that that form of organization exist. Immediate benefit to the local practitioner may not be evident. There may be individual instances that afford ground for complaint; but whatever tends to dignify accountancy in the esteem of the business community and broadens the demand for the services of accountants results in the end in advantage to practitioners wherever situated. And I maintain that the branch-office policy comes within the range of that statement.

I have mentioned that in the preparation of this paper I had before me criticisms that have been made of the branch-office system. These will now have consideration. It has been said that branch offices are undesirable because

> There are always local accountants in cities large enough to attract branch offices. Such local accountants are probably members of the institute or, at any rate, certified public accountants. The establishment of a branch office of a large firm militates against the development of the local practitioner.

No advocate of the branch-office system can regard this ob-

jection with indifference. If it be true, it must evoke sympathetic consideration, as being what is considered a just grievance by those who feel that they suffer because of the conditions. But it cannot be admitted that even if true the objection can be final as against the system. If by the operation of branch offices a service is given to the business world which cannot be attained by any other means, then that consideration is paramount. The profession must keep abreast of the demands upon it or sacrifice something of its prestige.

It may well be questioned, however, whether the objection is as substantial as it may appear to be. Certain demands can be met adequately only by accountants with widespread organizations, and by ability to meet these demands the work of the profession as a whole enjoys a prestige it could not otherwise achieve. In the final result the local practitioner benefits from this condition, as well as the larger firm.

It is said also that branch offices are undesirable because

(1) The opening of a branch office involves an effort to establish a clientele. Branch offices may go to extremes in efforts to attract clients.

(2) In some cases representatives of firms which make a specialty of the introduction of systems have opened offices, introduced systems and moved on before the aftermath.

(3) Branch office managers are frequently guilty of condescension toward local practitioners and adopt an air of superiority not always justified.

(4) Employees of local practitioners are frequently approached by representatives of larger firms and offered inducements to leave their employers.

(5) In a few cases representatives of large firms have attempted to intimidate clients of other accountants by threat of financial pressure from holders of the client's commercial paper.

None of these faults is inherent in the branch-office system. I am concerned only to present the case for that—not to defend an impolitic or improper course pursued by individuals. If the question were to be discussed on that plane, the large firm could cite objectionable practices by local practitioners. We need not hesitate to confess that there is room for improvement with regard to various conditions that exist in the profession, and it is a matter

for gratification that the council of the institute is working consistently for better things in all respects.

Other criticisms that have been made are these:

(1) The larger the practice and the greater its scope, the less possibility there can be of personal contact of client and practitioner.

(2) Reports prepared by a branch office are not always reviewed by members of the firm, and such a condition tends to commercialism.

(3) The head office cannot supervise the activities of branch-office managers. Bad work and unethical conduct may go unnoticed for some time.

(4) Large firms with many branch offices may send inferior assistants to do branch-office work. The result may be superficial and hasty service which would tend to depreciate the value of all accounting service.

These objections are more closely relevant to the merits of the case than those cited just previously, and they demand more particular consideration.

The objection regarding loss of personal contact assumes that it must necessarily be between a principal in the accounting firm and the client. As against this, experience demonstrates that all requirements of the situation are adequately met when the interests of the firm are in the hands of a well chosen representative, directed and controlled by a partner. If that were not true the branch-office system would fail because of an insuperable defect. That it does not so fail is proof that this particular objection does not touch upon something fundamental.

The other three objections involve the effective control of the operations of their branch offices by the principals in the firm. With regard to this I assert that there may be built up under the branch-office policy an organization against which these objections cannot justly be urged. By the training of the men who are to represent the firm in different localities; by a district organization which secures effective supervision over all offices by a partner in the firm; by building up a good morale throughout the organization, it is feasible to attain a standard of practice creditable to the profession and consistent with ideals of a high order.

It need not be contended that in practical operation the system as it is followed to-day is without faults. But the emphasis is to

be placed on the service it in fact gives; and the ultimate question involved is one not to be answered by factitious objections, but on broader lines. That question is whether the objections which can be urged have enough merit to condemn the system. The answer must be *No*. Any weaknesses that appear in it should be remedied. The operation of the system must and can be according to high standards. But there is no substitute that can provide so adequately for that which the branch-office system accomplishes. If justification is really necessary, it is to be found in the service the policy makes possible.

Advisory Accountancy *

By William B. Gower

On an occasion such as this, a representative gathering of our national body of public accountants, a body which contains all that is highest and best in the profession, it is fitting that we glance at certain phases of the remarkable evolution in the science and application of accountancy and in the opportunities for service that the profession affords, which has taken place during the past twenty years. We ourselves are so immersed in the phenomena, we are living so close to the manifestations, that we scarcely realize their extent and significance.

Not so many years ago one of our leaders deplored the fact that in this country the profession had not obtained that full and complete recognition which had been accorded to it in Great Britain; but he declared that the future was with the rising generation. His optimism has been fully justified; but even he could hardly have foreseen the extent of our development, our achievements, our recognition by the community or the growth of our service and opportunities. We have risen to man's estate; we have discarded the old leading strings; we no longer rely upon parental guidance and instruction; we recognize no outside authority; we have surpassed the achievements of our predecessors, and our standing and usefulness in the community are not surpassed elsewhere.

Perhaps the greatest of our achievements is one which, in our crowded and strenuous efforts to keep abreast with our expanded business, we are apt to overlook. I refer to our accounting literature, particularly the works which have inquired into and thrown a flood of light upon the rational bases and principles upon which rules of accounting practice and procedure rest. I doubt whether, even yet, the importance of this achievement has been sufficiently recognized. It is not so long ago, however, that the writings and teachings of accounting authorities were confined almost exclusively to practice and procedure. We were taught what practice

* A paper presented at the annual meeting of the American Institute of Accountants, at Washington, D. C., September 22, 1920.

was right and what was wrong, how to correct abuses, how to analyse accounts, classify business facts, ascertain and distribute costs, prepare financial statements, and how to deal with unusual as well as ordinary situations and circumstances. It was inevitable, however, as time went on, that a demand would arise within the profession itself for inquiry as to how far accounting practice and procedure rested upon permanent and fundamental principles, as distinguished from custom, tradition and mere expedients. We have seen this demand met in this country in the published works of university professors in accounting, among whom may be cited Professors Sprague, Hatfield, Paton and Stevenson. The distinctive characteristic of these writings is the framework or background of broad general principles, determined by deductive reasoning and represented as the rational basis of accounting. These general principles are relied upon for the solution of many difficult problems of the balance-sheet, of corporate proprietorship and of the determination of net revenue. The attempt is made to bring practice and procedure within the scope of these principles.

Time was when it was thought sufficient for the public accountant to be familiar with the practice or procedure and to be able to answer inquiry by saying, "Such and such is the practice, or such and such is the procedure," as the case might be. If his dictum was questioned, the accounting manuals could be relied upon for confirmation—and for little else. Those happy and simple times have passed, never to return; the extraordinary growth in the volume of modern business and in the complexity of the industrial situation has supervened. To-day the public accountant can no longer place sole reliance upon a knowledge of practice and procedure, however extensive and minute, and the chief reason for this has been his contact with the legal mind. Not only do lawyers rely upon him for technical advice, but the public accountant is frequently relied upon for expert testimony before the courts, in such proceedings as patent accountings, profit accountings and controversies relating to income and profits taxes. The legal mind is not impressed with the dicta of public accountants that such and such is the practice—it requires a great deal more than that and insists upon explanation of the rational basis for the practice and a demonstration of the broad underlying

principles. It is this development in the scope of the accountant's work to-day which makes it vitally important that we should be familiar, not only with the practice, but with the principles which govern.

In this phase of advisory accountancy it is most important to avoid the easy assumption of one of our pioneers that the principles of accountancy may all be determined by a priori reasoning and in no way depend upon the customs and tradition which surround the art, or, as expressed by another writer, that most accounting problems admit of being carried back to elementary first principles. Unquestionably, a keenly logical mind is a most useful part of an accountant's equipment, but the failure to realize that important parts of our practice depend upon custom, tradition and expediency, and do not yield to rigorous logic, has been responsible for serious error. To those who are required to give technical advice to lawyers and before the courts, a thorough knowledge is indispensable, not only as to the practice which rests upon broad general principles, but also as to the practice which embodies custom, tradition and expediency.

The accountant must be familiar both with the practice and with the fundamental logic underlying the theory of each accounting question. For in accounting as in law the science is in a constant state of flux, and there is a persistent struggle between logic and custom, or, to put it another way, between what was logical in the past and what has become logical in the present. It is common knowledge, even to the layman, that our legal precedents have, many of them, been handed down to us from the middle ages. At the time when these precedents were created they were based squarely on sound logic, but progress and changing conditions have rendered such precedents no longer in accord with strict logic. In many cases the old precedents have become so illogical that they have been whittled away or completely overturned. In other cases the Anglo-Saxon mind, such a stickler for precedent, has clung to and maintained the old rules in spite of the changed conditions which make the old rules illogical and obsolete.

A familiar illustration of the changing rules of law due to changed conditions and greater education of the masses, etc., is furnished by the decisions with regard to seals upon instruments.

For many years seals were necessary on certain classes of instruments and they were void in the absence of a seal; and on the other hand once a seal was put upon an instrument it could not be attacked for lack of consideration. Both rules have been whittled away until to-day practically all instruments are binding even though no seal be affixed, and on the other hand they are generally open to attack no matter how many seals are affixed. Yet the effect given to the seal in the middle ages still lingers and produces odd results. A release under seal cannot be questioned and is binding without consideration; whereas if the seal be omitted a lack of consideration is a complete defense. So also the time within which an action may be brought on an instrument under seal is twenty years and the time within which such an action may be brought where the seal is omitted is only six years.

As the lawyer must recognize the deviations from the lines of logic caused by the forces of the past and must recognize the law as it actually exists and not as it should exist from a purely theoretical standpoint, so the accountant must recognize the potent influence of past custom and must follow rules that are not always logical, where those rules are well established and are generally observed.

I need mention only a few instances of this conflict between precedent and logic, so far as accounting practice is concerned, which an advisor must keep constantly in mind. The best illustration is the inventory valuation rule of "cost or market price, whichever is the lower." It is a rule which has a considerable vogue; it received the official endorsement of the London committee of consulting accountants in their report to the board of inland revenue; it was declared by that committee to rest on a sound principle and theory, and to be of universal application; it was adopted by the British board of inland revenue, and finally adopted by the internal revenue bureau in this country. Yet the rule is to-day indefensible from a purely theoretical standpoint, as many writers have pointed out; and both the British board and the internal revenue bureau now admit that it is not adapted to all cases.

Another illustration may be cited: the booking of capital losses arising from fire, shipwreck, default of capital investments, depletion of natural resources. Professor Hatfield has pointed out in his study of this subject that while it may be logical

to claim that all losses should go to profit and loss account, and not direct to some other proprietorship account, such a claim does not at all conform to accounting practice of any land or time.

Other illustrations will occur to those whose advisory work brings them in contact with contentious accounting questions, such as the rule under which fixed assets are retained in the accounts at cost and may not be subsequently revalued and the rule against booking interest on capital owned, as a manufacturing charge complementary to interest on borrowed money, and the rule against booking as a profit a saving of expenses such as vendor's profits taxes paid under contract by a purchaser of property. A variant of this latter rule arises in the private accounts of individuals, in the saving of 2 per cent income taxes on the interest from bond investments containing the so-called tax-free covenant clause. The tax bureau contends that logically this saving is in the nature of additional income to the individual; the bureau will hardly assert, however, that under accepted accounting practice such an item would be entered in the books of the individual as additional income.

In our younger days, before the immense development of commerce and industry, the main duties of the accountant in this country were said by one of our leaders to consist of the audits of the accounts of corporations, firms and individuals. His special skill conformed at that time to the stage of accounting practice then existing, and it related mainly to the best, the safest and the most economical methods of keeping the accounts and records and to presenting clearly and concisely the financial condition at a given date and the results of operation for a given period. The advice expected and required from us in those days was limited naturally by the condition of business and was confined in a great measure to technical methods, to improvement and standardization of accounts, to safeguards against waste and fraud, to economy and to the best means of conveying prompt and useful information to owners. The immense expansion of our commercial life gradually emphasized the importance of applied accounting and created a greater demand for competent advice of this kind. The advent of combinations, trusts, consolidations and holding companies and the evolution of corporate securities which this type of organization brought with it opened a new

chapter in accounting science and raised a series of accounting questions of extraordinary complexity, which we alone could solve. The development of large scale production compelled us to close, analytic study of the phenomena of costs and the problems of cost accounting. The need for efficiency and economy in productive processes created a new demand upon our skill and advice. Finally, the initiation and subsequent expansion of federal and state supervision, control and regulation of public utilities and the tendency toward similar authority over important basic industries resulted in the formation of a multitude of commissions, wielding considerable powers and demanding a mass of statistical and accounting information as a basis for rate-making and price-fixing. As a result of these important changes and developments our duties and opportunities were immensely expanded, for our advice and coöperation were indispensable to the new situation and conditions.

It is evident that these increasing demands upon the profession required a more extensive knowledge and equipment and a higher standard of ability and skill than sufficed in the early days; but we have been equal to the demands and have met them fully. Necessity compelled us to closer study, required of us creative ingenuity and forced us to the solution of all the problems with which we were confronted. The rapid expansion of our experience and the greater call upon our skill involved our own education on a liberal scale. We have been brought into close contact with the affairs of business, of finance, of management and executive control, of trading, rate-making, buying, producing, transporting and marketing. Heretofore we had regarded such matters as somewhat outside our province, as matters upon which we were bound to consult with other business advisors having special skill in those directions. We had looked at them rather casually and incidentally, as their manifestations appeared in the accounts and records over which we worked. To-day it is recognized that our experience has brought with it that special skill and judgment which is required for the solution of important and practical business questions.

Many of us can testify from personal experience to the wide range of practical business questions upon which our advice is now sought by financiers, owners, creditors, even by executives

and managers. The questions may relate to finance, such as an original investment or purchase or a subsequent acquirement of an interest or the financing of a contemplated expansion of the business or a temporary financing necessitated by growing inventories or the payment of cash or stock dividends. They may relate to questions of business policy, such as expansion of the enterprise, or embarking on new lines of trade or manufacture, acquisition of properties, volume of output and its relation to overhead expenses, cessation or curtailment of unprofitable lines, accumulation of inventories, work in process, or finished goods, the question of branches and departments and the policy of credits and discounts. They may relate to questions of management and administration, economical production, the prevention of waste, extravagance and useless expense, even questions of personnel. It is true that our early professional training does not incline towards a special skill in such practical business questions, but the modern growth of our service and opportunities has forced upon us a wide business experience, while our continual and close reading of the statistics of both successful and unsuccessful business enterprises has necessarily enlightened and informed us. It is this wide knowledge gained by experience and by our facility in reading, understanding and drawing correct conclusions from the business history of such enterprises which has caused our advice to be sought and valued upon practical business questions.

During the past three years the advisory functions of the public accountant have reached their highest stage as a result of huge taxes based upon profits, excess profits and invested capital. These factors of invested capital and profits are intimately related to what has been termed the "essence of accounting," namely the balance-sheet and the profit and loss account. These tax laws are so saturated with accounting concepts, principles and terminology that they are almost unintelligible to laymen and difficult of comprehension even by lawyers. The saturation may be illustrated by a recent dictum of the treasury to the effect that a certain phrase in the statute "incorporates into the law by reference the entire body of principles of accounting relative to the determination of surplus." Of course, such a dictum will not bear scrutiny; but, no matter whether we regard it as a rhetorical flourish or a flight of exuberant fancy or a phrase by means of which a con-

tentious subject is dismissed, the dictum indicates the extent to which these tax laws are permeated with accounting ideas. They have required for their administration a mass of regulations and decisions still more impressed with accounting principles and practice and equally difficult of comprehension by the uninitiated.

The advisors responsible for the decisions upon which the administrative tax regulations are based were quite aware that accounting principles and practice involved many uncertainties, many disputed questions and many divergent usages and methods; and, as Professor Hatfield pointed out, "there is no ultimate arbiter to whom appeal can confidently be made." The exigencies of the situation, however, compelled these advisors to make decisions on these disputed questions, in order that administration of the laws might proceed. It was natural to expect that on close questions these decisions would be favorable to the government and equally natural that the taxpayer who was placed at a disadvantage by these decisions would question their validity. The disputed points involved incredibly large sums of money, and taxpayers in their extremity have been compelled to call upon us for advice and help to sustain the positions and theories upon which they relied. Our advice and assistance on these matters have been indispensable to the taxpayers and to the government during the past three years. In the near future, when many of these questions involving immense sums of money must be decided in the courts, our advice and assistance will be required and will be effective in proportion to the knowledge and skill which we bring to the discussion of the principles, customs, traditions, usages and methods which surround the art.

The larger part of the advice required from us in these income and profits tax matters deals with conditions arising from facts and business transactions of the past: situations the essentials of which no one can alter, but regarding which more than one interpretation and view may be possible and more than one treatment available. There is another class of tax advice, however, which is most important, and to which we may refer as anticipatory or precautionary: a warning for the unwary and incautious. In these days practically all substantial business transactions entail tax consequences, and the failure to foresee these consequences may be very costly. Whether it concerns the disposal

of property of all kinds or the terms of its sale or the making of investments or the financing of a business, or the form under which property shall be held or business conducted or the liquidation of a business or the payment of dividends, we are forced to keep in mind that all roads lead to the tax collector's office. In these circumstances it is not sufficient to rely upon general or even special knowledge of the principles and practice of accountancy; nor even upon intimate knowledge of the anatomy of these tax measures and the infinity of administrative rules and regulations. In certain cases, particularly where unusual transactions are contemplated, something more than this equipment is required—and that is a measure of foresight as to the position which the tax bureau is likely to take and to which it is likely to adhere.

In these tax matters, most of the questions put before us involve accounting rules and practice which are well settled and are supported by general usage and custom and the weight of authority. On the other hand, many questions involving large sums are brought to us which hinge upon accounting uncertainties and accounting "rules competing for acceptance." There being no ultimate arbiter to whom appeal can confidently be made, the advisor is put upon his own resources and must rely upon acquired knowledge of all phases of the question and upon clear and skilful presentation of the issues. Under these conditions, the institute is playing an important part in opening the columns of The Journal of Accountancy to free and helpful discussion and in obtaining the views of specialists on accounting questions peculiar to various industries. It is filling the unavoidable gap in our accounting manuals and textbooks by dealing with the special problems of each industry. By such means, better than by any other, this institute exerts a real authority in accountancy matters, justly proportioned to its unique national position.

The Journal of Accountancy

Published monthly for the American Institute of Accountants by
The Ronald Press Company, 20 Vesey Street, New York, N. Y.
Thomas Conyngton, president; L. G. Henderson, secretary;
Hugh R. Conyngton, treasurer

A. P. RICHARDSON Editor

EDITORIAL

"A Profession—Not a Business"

Probably the most interesting and illuminating of the discussions which occurred at the annual meeting of the American Institute of Accountants in Washington last month was that which concerned the general question of advertising and business-seeking. The result of the discussion was a decision that there be appointed a special committee to collate specimens of advertising by accountants and to consider the desirability of some form of corporate propaganda for the advancement of the public knowledge of accountancy and its merits.

It is therefore reasonable to suppose that during the current fiscal year of the institute a great deal of attention will be paid to the matter of publicity on the part of accountants. With that question there will certainly be consideration also of various practices of members of the profession against which there is serious objection by other members of the profession.

Advertising in its mildest form, such as the heavy-faced type in a telephone directory or a simple card of announcement in a magazine or newspaper, is so close to the border line between what is ethical and unethical that it will probably be a long while before a definite decision as to the propriety of any given form of simple advertising will be reached. On the question of the grandiloquent assertion of superiority or the merely execrably bad taste of some other advertisements it is to be hoped that the institute as a body will take a definite stand without great delay.

In the early days of the profession in this country nearly everybody advertised in one way or another, and it is absolutely

certain that there will always be advertisement of a kind—but that need not imply the printed word.

We have repeatedly affirmed that the accountant's name at the foot of a published balance-sheet is the most effective form of advertising, and yet no one could possibly raise any objection thereto. The statement by a member of the institute during the discussion in Washington to the effect that he had been widely advertised as a result of his connection with a notorious case was undoubtedly true, and yet no one could object to such advertising.

A part of the time of the next meeting is to be set aside for further discussion of the question of publicity in all its forms and it is hoped that members and associates will give the matter careful consideration during the year so that they may come prepared to discuss intelligently what has become one of the vital topics of the day in accounting.

Anything which serves clearly to explain why advertising, soliciting and the like are unprofessional should be given the widest circulation, and accordingly we have asked and received permission to reprint a short editorial which appeared recently in *Haskins & Sells Bulletin,* a publication restricted in its circulation to the members and employees of the firm.

It would be difficult to express more emphatically and effectively the distinction between business and profession than it is expressed in the following comment:

A profession puts service above all else. The professional man does not blatantly advertise his accomplishments; neither does he urge his services unduly on those who may have need of them.

The relation between accountant and client is like that which exists between physician and patient. It is a confidential one. It grows out of a desire on the part of clients for highly skilled personal services.

The thought of a physician going about from house to house soliciting practice is exceedingly offensive. Imagine a physician calling at the front door to inquire if there is anyone in the house with an organic disease requiring treatment. Imagine his inquiring as to the attending physician and what are his fees. Think of his offering to take the case at a lower figure.

The analogy unfortunately is too often found in the field of accountancy. There are those engaged in professional accounting work who have no conception of the ideals of a profession.

They go deliberately about the work of taking engagements away from other accountants. They canvass the list of those who might need the services of professional accountants. They find out who, if any, are the accountants retained. They inquire as to the fees. They brazenly offer to render the service for less.

The client, or the potential client, not always grasping as clearly as he might the philosophy underlying the accountancy profession, is sometimes interested and afterwards attracted by the thought of saving money. He does not stop to consider the unprofessional tactics of the solicitor. He overlooks the possibility of a difference in the quality of the service. He does not realize that the first price is only a scheme for obtaining the engagement and that later the fee will be advanced. He possibly does not know that accountants with high ideals regard their work as taking the form of professional practice and not as a business.

There is only one thing to do when some unprofessional contemporary takes away an engagement. There is only one recourse when those who style themselves professional accountants go from office to office hawking their wares. The consolation is to be found in harder work and better service; service of the kind which is so much better than any one else in the same field renders, that those who have need of such service will get in the way of one another in seeking it.

The professional man is expected to make himself known. The establishment of acquaintance which comes through getting about and mixing in the business and social world is eminently proper. The achievement of that psychological status which grows out of frequent and intimate meeting with men of affairs is nothing upon which to frown. Dignified, genteel, and diplomatic contact with prospective or potential clients may not be regarded as unethical. But the professional man may not become a canvasser. He may not blow his horn as does the peddler. When he reaches the stage wherein satisfaction in the performance of work well done means more to him than financial reward, he will have attained the coveted realm. Such is the concept which distinguishes a profession from a business.

Annual Meeting of the American Institute of Accountants

The annual meeting of the American Institute of Accountants held in Washington last month was in many ways the most successful in the history of the institute and of its predecessor, the American Association of Public Accountants. There was an average attendance of approximately 150 members at every session

of the meeting and the general participation in discussions indicated that those who were present were much interested in the various questions before the meeting. Where differences of opinion existed they were harmoniously discussed, and the obvious desire of every person present was the furtherance of the best interests of the profession. Excellent papers were read; important changes in the constitution and by-laws were approved, and other significant things were accomplished.

The most important of all, however, was the remarkable success which attended the effort to float an issue of bonds to cover the purchase of the institute's new building at 135 Cedar street, New York.

Practically as fast as the subscriptions could be noted they were received, and the entire amount, $90,000, was underwritten. The great majority of the subscriptions were in amounts of $1,000 and were distributed from coast to coast and from Canada to the gulf, as will be seen by the report of the meeting which appears elsewhere in this magazine.

American Institute of Accountants

PROCEEDINGS OF THE ANNUAL MEETING HELD AT WASHINGTON, DISTRICT OF COLUMBIA, SEPT. 21 AND 22, 1920

Tuesday, September 21, 1920—First Session

The regular annual meeting of the American Institute of Accountants was called to order at 10 A. M., Tuesday, September 21, 1920, at the New Willard Hotel, Washington, District of Columbia, President Waldron H. Rand presiding.

The meeting was opened with prayer by the Rev. Hamilton P. Fox, of Washington.

Minutes of the preceding meeting as published in the year-book of 1919 were approved without reading.

The president then presented his report, which was accepted.

The statement of accounts prepared by the treasurer, accompanied by the report of the auditors, was read and accepted.

The secretary announced that the minute book of the council was on the table for the inspection of any member during the course of the meeting.

The report of the council was read.

It was resolved that the report of the council be accepted and that action be taken thereon with respect to the recommendations contained in the report.

The first recommendation in the report was to the effect that members be asked to subscribe to $90,000 of 7% 20-year bonds to be issued by the real estate corporation to be formed to hold the property at 135 Cedar street, New York, contract for purchase of which on behalf of the institute had been made.

Reports of the sub-committee containing subscription blanks were distributed.

After further explanation of the matter by Arthur W. Teele, Edward E. Gore and the secretary, members were invited to subscribe.

At the suggestion of a member that subscriptions of less than $1,000 be accepted, a few smaller subscriptions were made. The total amount subscribed by members and associates was $82,800, most of which was subscribed in sums of $1,000.

It was announced that the difference between the sum subscribed and the total amount required had been underwritten by several of the larger firms, on the understanding that any members who had not subscribed at the meeting and desired to participate would be able to do so upon application to the secretary, provided the supply of available bonds was not exhausted.

Subscriptions were made by the following:

Albert T. Bacon, Chicago
Barrow, Wade, Guthrie & Co. New York
R. J. Beaman, Cincinnati
T. W. Betak, Chicago
George L. Bergen, New York
John A. Bowman, Columbus
Harvey S. Chase & Co., Boston
Earl S. Clark, Providence
L. P. Collins, Pittsburgh
Walter A. Coy, Cleveland
J. D. M. Crockett, St. Louis
Ernest Crowther, Pittsburgh
Robert Douglas, Boston
Robert Dysart, Boston
Lewis G. Fisher, Providence
Edward E. Gore, Chicago
Elmer L. Hatter, Baltimore
Charles L. Hehl, Baltimore
W. P. Hilton, Norfolk
E. R. Hudders, New York
F. H. Hurdman, New York
Hutchinson & Smith, Dallas
Benjamin Jacobs, New York
David A. Jayne, Charleston, W. Va.
J. Porter Joplin, Chicago
Jordan & Jordan, Portland, Me.
Kohr, Brubaker & Fisher, Cleveland
John J. Lang, St. Louis
W. E. Langdon, Columbus
Charles H. Langer, Chicago
Page Lawrence, Denver
Loomis, Suffern & Fernald, New York
Lybrand, Ross Bros. & Montgomery, Philadelphia
John C. McAlpine, Philadelphia
W. R. Mackenzie, Portland, Ore.
J. S. Matteson, Duluth
Meldrum & Meldrum, Louisville
Orlando C. Moyer, Boston
Mucklow & Ford, Jacksonville
Nau, Rusk & Swearingen, Cleveland
Maurice E. Peloubet, New York
Peter & Moss, Dallas
Pogson, Peloubet & Co., New York
Joseph M. Pugh, Philadelphia
Waldron H. Rand, Boston
George Rea, Newark, N. J.
Ernest Reckitt, Chicago
Seth L. Roberts, Portland, Ore.
Adam A. Ross, Philadelphia
John R. Ruckstell, San Francisco
Scovell, Wellington & Co., Boston
E. W. Sells, New York
E. G. Shorrock, Seattle
Arthur B. Sinclair, New York
William A. Smith & Co., Memphis
W. T. Sunley, Detroit
W. S. Sutton, Pittsburgh
Max Teichmann, Baltimore
Herbert M. Temple, St. Paul
T. A. Thurston, El Paso
Touche, Niven & Co., New York
Vannais, Troub & Co., Hartford
W. F. Weiss, New York
James F. Welch, Paterson, N. J.
F. F. White, Montclair, N. J.
W. S. Whittlesey, New York
John R. Wildman, New York
Raymond D. Willard, Boston

The next recommendation in the report of the council was to the effect that rule 11 of the rules of professional conduct should be amended by omitting the last sentence in the rule. As amended the rule would then read:

"No member shall render professional service, the anticipated fee for which shall be contingent upon his findings and results thereof."

It was moved, seconded and unanimously resolved that the recommendation be adopted.

The report of the committee on constitution and bylaws recommended by the council for action by the institute was next considered.

The following amendments were unanimously adopted:

Constitution: Article II, section 2, add a new paragraph.

"(d) Accountants in practice who shall present evidence of preliminary education satisfactory to the board of examiners, who shall have been in practice on their own account or in the employ of a practising accountant for not less than ten years, one year of which shall have immediately preceded date of application, who shall be recommended by the board of examiners after examination and elected by the council."

Article III, section 3, after the word "secretary" on the first line add "of the institute."

As amended the section would then read:

"Section 3. The council shall elect a secretary of the institute who shall also act as an executive officer under the direction of the council. The secretary may be chosen from without the membership of the institute, but he shall have the privilege of the floor at meetings of the institute, the council and the executive committee.

Article IV, section 3. Add at end of section:

"In lieu of a meeting of a committee the chairman may submit any question to its own members for vote by correspondence, and any action approved in writing by not less than two-thirds of the whole committee shall be declared an act of the committee."

Bylaws: Article IV, section 3. From fourth line delete "\$15.00" and insert "\$25.00."

The section as amended would then read:

"Section 3. The dues for each fiscal year shall include subscription to THE JOURNAL OF ACCOUNTANCY and to the year-book of the institute and shall be as follows:

"By each member..............................	\$25.00
"By each associate............................	10.00"

The following proposed amendment was read:

Article IV, section 4. Add at end of section:

"Members and associates of the institute who shall have been members or associates in good standing for ten years may, upon reaching the age of seventy years, be exempt from further payment of dues."

The following resolution was moved and seconded:

Resolved, that the motion to adopt the proposed amendment to article IV, section 4 of the bylaws, be referred for reconsideration and report at the annual meeting of 1921.

The motion was carried.

In response to requests the report of the special committee on administration of endowment was read for the information of members.

The following resolution was adopted:

Resolved, that the acts of the council during the past year be and hereby are ratified and confirmed.

The following resolution was moved and seconded:

Resolved, that the committee on professional ethics and the council of the institute sitting as a trial board be and hereby are instructed neither to present, entertain nor hear any complaint against a member of the institute alleging a violation of any of its rules or bylaws when such complaint is made by an employee or former employee of such member, and is predicated on knowledge derived in consequence or because of such employment.

It was moved as an amendment that consideration of the matter be postponed until the following day.

The amendment was put to vote and lost.

The original motion was put to vote and lost.

Tuesday, September 21, 1920—Second Session

The meeting was called to order at 2 P. M.

A paper entitled *Supervising the Work of the Accounting Staff,* by John R. Wildman, was read and followed by discussion.

Edward E. Gore, appointed as a committee of one by the president to prepare resolutions relative to the deaths of members and associates of the institute which had occurred during the past year, presented the following report:

To the president and members of the American Institute of Accountants.
GENTLEMEN:

Your committee appointed to give expression to the feeling of the institute occasioned by the death of certain of its members occurring within the year now closing, respectfully submits the following resolution to be communicated to the family of each member deceased within the year:

"Resolved, that the members of the American Institute of Accountants learn of the death of their fellow member with profound sorrow and extend to his family their sincere sympathy, asking as his friends the privilege of sharing the grief which those nearer to him are called upon to endure."

The committee submits that form of resolution to apply to each of the deceased members named in the report of the secretary. With respect to two of the members who have died, who were men of outstanding accomplishments and of great prominence in the institute, the committee makes a special report and recommends the adoption of the following resolutions:

The American Institute of Accountants in annual meeting assembled, being apprised of the death of Seymour Walton, one of its first members and for many years a leader in accountancy education, desires to record its appreciation of him as a gentleman of culture, as a practising accountant of high standing and as an educator of the first class.

It further desires to record the grief of its members that their friend and colleague has been taken from them, and that the gentleness of his manner

and the charm of his presence and his conversation have become naught but a memory.

And it further desires to record its feeling of obligation to him for the great work he has performed in its behalf, in behalf of the literature of his profession and in behalf of those who are to be the standard bearers of the accountancy of the future.

*   *   *   *

The American Institute of Accountants learns of the tragic and untimely death of Charles Neville, one of its honored members, with the deepest grief and the most sincere regret.

It recalls the splendid service he has rendered as a member of its council.

It is mindful of his fidelity to the interests of his clients and to the best traditions of his profession as a practising public accountant.

It remembers the great service he so loyally and unselfishly rendered to his country in the darkening hours of war and in the brighter days thereafter.

And with these memories before it the American Institute of Accountants realizes and states its appreciation of Charles Neville as an accountant, as a counselor and as a patriot, and, while expressing to his bereaved family its sympathy in this sad hour, it claims a solemn pride in him and in what he has accomplished.

The report of the committee was unanimously adopted.

It was resolved that the resolutions adopted with respect to Seymour Walton and Charles Neville be suitably engrossed and furnished to the respective families of the deceased members.

A paper entitled *The Growth and Effect of Branch Offices,* by Frederick A. Ross, was read.

Wednesday, September 22, 1920—First Session

The meeting was called to order at 10 A. M.

The following officers and members of the council were unanimously elected:

President: Carl H. Nau.

Vice-presidents: T. Edward Ross, W. P. Hilton.

Treasurer: J. E. Sterrett.

Council for five years:

John F. Forbes.
J. Porter Joplin.
Waldron H. Rand.
F. A. Ross.
Frederic A. Tilton.
Elijah W. Sells.
William Jeffers Wilson.

Council for four years:

Ernest Crowther.

Council for two years:

Clifford E. Iszard.

Council for one year:

John R. Ruckstell.
Joseph P. Hutchinson.

Upon his election as president of the institute, Carl H. Nau assumed the chair.

The chairman called upon George Edwards, of Toronto, representing the Dominion Association of Chartered Accountants, to address the meeting.

Mr. Edwards expressed his appreciation of the welcome accorded to him and the hope that accountants of Canada and the United States would be brought nearer together.

A letter was read from Charles R. Trobridge, who had attended a meeting at the treasury department for consideration of forms for federal tax returns, asking that members having suggestions to make relative to forms should communicate with the institute without delay.

The chairman announced that accountants representing certain groups of states would hold meetings immediately following the session then in progress to discuss arrangements for holding regional meetings as outlined in the report of the executive committee.

Walter Mucklow, of Florida, moved the appointment of a committee on terminology to carry on the work of similar committees of past years.

The motion was seconded and adopted.

The chairman called upon W. Sanders Davies, chairman of the committee on ethical publicity, to discuss the subject of advertising.

Mr. Davies' remarks were followed by general discussion.

It was moved and seconded that the discussion be printed in the form of a confidential circular and distributed to the members.

The motion was lost.

The names of Horace P. Griffith and Edward P. Moxey, both of Pennsylvania, were placed in nomination for auditors for the current fiscal year.

The members nominated were unanimously elected.

It was moved and seconded that the programme of the annual meeting of 1921 should provide a definite place for further discussion of the subject of advertising and publicity in general.

The motion was adopted.

Upon motion, duly seconded, it was unanimously resolved that the meeting extend a vote of thanks to the board of examiners for the great services performed by that board.

A rising vote of thanks was accorded to Will-A. Clader and A. M. Pullen, of the committee on meetings.

A rising vote of thanks was given to Waldron H. Rand, retiring president, for his faithful services.

Wednesday, September 22, 1920—Second Session

A paper by William B. Gower, entitled *Advisory Accountancy,* was read.

A rising vote of thanks was given to Mr. Wildman, Mr. Ross and Mr. Gower for the papers which they had presented.

The meeting adjourned sine die.

COUNCIL

Regular Meeting, Monday, September 20, 1920

The regular meeting of the council of the American Institute of Accountants was called to order at 10 A. M., Monday, September 20, 1920, at the New Willard Hotel, Washington, District of Columbia.

The following were present:

Waldron H. Rand, president, in the chair.
Arthur W. Teele, vice-president.
J. E. Sterrett, treasurer.
A. P. Richardson, secretary.

Harvey S. Chase	W. R. Mackenzie
Hamilton S. Corwin	J. Edward Masters
J. D. M. Crockett	James S. Matteson
W. Sanders Davies	Overton S. Meldrum
John F. Forbes	Walter Mucklow
J. S. M. Goodloe	John B. Niven
Edward E. Gore	Adam A. Ross
Elmer L. Hatter	W. Ernest Seatree
William P. Hilton	E. G. Shorrock
J. Porter Joplin	W. A. Smith
F. W. Lafrentz	Edward L. Suffern
Page Lawrence	C. M. Williams

The meeting was opened with prayer.

The minutes of the preceding meeting as printed and distributed were approved.

The secretary announced that the minutes of the executive committee were on the table and would remain for the inspection of any member of the council during the course of the meeting.

Records of mail ballots Nos. 10 and 11 were read and approved.

The meeting adjourned to convene as a trial board.

The following were present:

Harvey S. Chase	Overton S. Meldrum
Hamilton S. Corwin	Walter Mucklow
J. D. M. Crockett	Carl H. Nau
W. Sanders Davies	John B. Niven
John F. Forbes	Waldron H. Rand
J. S. M. Goodloe	Ernest Reckitt
Edward E. Gore	Adam A. Ross
Elmer L. Hatter	W. Ernest Seatree
William P. Hilton	E. G. Shorrock
J. Porter Joplin	W. A. Smith
F. W. Lafrentz	J. E. Sterrett
Page Lawrence	Edward L. Suffern
W. R. Mackenzie	Arthur W. Teele
J. Edward Masters	F. F. White
James S. Matteson	C. M. Williams

F. F. White, representing the committee on professional ethics, appeared in support of charges preferred by a member of the institute against another member, to the effect that such member had infringed the rules of the institute, in that in violation of the second rule of the rules of professional conduct of the institute he did prepare a certain balance-sheet which contained an essential mis-statement of fact or omission therefrom of such a fact as would amount to an essential mis-statement, and did so prepare such balance-sheet either wilfully or with such gross negligence as to be inexcusable.

This complaint had been considered by the committee on professional ethics, which found prima facie evidence of a breach of rule 2, and had so reported to the executive committee, which in turn had prepared formal charges against the member accused.

Complainant and respondent presented their evidence in person.

After consideration of the evidence the following resolution was adopted:

Resolved, that the accused member be found guilty of violation of rule 2 of the rules of professional conduct, and that the council in admonishing such member does not wish to add any punishment in view of the fact that he has unconditionally stated to the council that he was in error in having concealed certain facts, and that he did not propose to do anything of a like nature in the future.

It was further resolved that the institute looks with disfavor on the concealment of any material facts in the preparation of a balance-sheet, operating statement or other statement or in any publication thereof.

It was resolved that the findings of the trial board be published without the names of the parties concerned.

The trial board adjourned.

The council convened.

The statements of accounts prepared by the treasurer were submitted and accepted.

A summary of the report of the board of examiners was read. The report was accepted and ordered printed in the year-book.

A supplementary report of the board of examiners recommending the election of certain applicants as members or associates was unanimously adopted, and the applicants were declared elected.

The report of the committee on professional ethics was read and accepted. It was resolved that the recommendations contained in the report be considered separately.

It was resolved that the recommendation of the committee that rule 11 be amended by the omission of the last sentence be referred to the institute for action.

The recommendation of the committee that rule 2 be amended by inserting after the words "essential mis-statement" in the fourth line a further clause, "or a failure to put prospective investors on notice in respect of an essential or material fact not specifically shown in the balance-sheet itself," was unanimously adopted.

As amended the rule reads:

(2) The preparation and certification of exhibits, statements, schedules or other forms of accountancy work, containing an essential mis-statement of fact or omission therefrom of such a fact as would amount to an essential mis-statement or a failure to put prospective investors on notice in respect of an essential or material fact not specifically shown in the balance-sheet itself, shall be, ipso facto, cause for expulsion or for such other discipline as the council may impose upon proper presentation of proof that such mis-statement was either willful or was the result of such gross negligence as to be inexcusable.

The report of the executive committee was read.

It was moved and seconded that the report be received and the recommendations be adopted, except those recommendations which should be referred to the meeting of the institute.

The motion was carried.

It was moved that all acts of the executive committee during the year be approved and ratified.

The motion was seconded and adopted.

The recommendation of the committee that the report of the sub-committee on building should be referred to the institute was unanimously adopted.

The recommendation of the committee that the council approve the proposed increase of dues of members, and that such increase be made retroactive to September 1st was unanimously adopted.

The recommendation of the committee that the letters C. P. A. and every other designation be omitted from the certificates of membership or any other publication of the institute, such as year-book, etc., was unanimously adopted.

The recommendation of the committee that the executive committee be authorized to pay the dues of members in financial difficulties was unanimously adopted.

The recommendation that a new committee be appointed to consider the question of chapter formation and that no further action be taken at this time was unanimously adopted.

The report of the committee on budget and finance was read.

It was resolved that an additional appropriation of $1,000 for the purchase of printing appliances for the offices of the institute be added to the budget.

The budget as amended was adopted.

On motion it was resolved that reading of the report of the committee on constitution and by-laws be omitted, in view of the fact that the report had been printed and distributed to all members of the institute.

It was resolved that the report be referred for action to the institute.

The chairman of the committee on ethical publicity stated that his committee had no written report to make and expressed the opinion that until

all members agreed not to advertise in any way the labors of his committee would be largely wasted.

The oral report of the chairman was accepted.

It was resolved that a committee be appointed to draft resolutions relative to the deaths of Seymour Walton and Charles Neville and other members of the institute who had died during the past year.

A summary of the report of the committee on federal legislation was read. The report was accepted and ordered printed in the year-book.

The report of the committee on publication was read.

It was moved and seconded that the report be accepted and that the recommendations contained in the report be approved.

The motion was unanimously adopted.

The report of the committee on nominations was read and accepted.

The report of the committee on state legislation was read and accepted.

The report of the special committee on procedure was presented and was approved for publication in the year-book.

The report of the special committee on administration of endowment was read and accepted.

The report of the committee on increased membership was read and accepted.

Under the heading of new business a letter was read from a member of the institute complaining against a circular issued by a firm consisting of members of the institute.

It was moved that the matter be referred to the committee on ethical publicity.

An amendment was offered to the effect that in addition to referring the matter to the committee on ethical publicity the council should go on record as disapproving the issuance of such circulars by any members of the institute.

The amendment was adopted.

The original motion as amended was adopted.

The meeting adjourned.

COUNCIL

Regular Meeting, Thursday, September 23, 1920

The regular meeting of the council of the American Institute of Accountants was called to order at 10 A. M., Thursday, September 23, 1920, at the New Willard Hotel, Washington, District of Columbia.

The following were present:

Carl H. Nau, president, in the chair.
W. P. Hilton, vice-president.
T. Edward Ross, vice-president.
J. E. Sterrett, treasurer.
A. P. Richardson, secretary.

Harvey S. Chase
Hamilton S. Corwin
J. D. M. Crockett
Ernest Crowther
W. Sanders Davies
John F. Forbes
J. S. M. Goodloe
Edward E. Gore
Elmer L. Hatter
J. E. Hutchinson
Clifford E. Iszard
J. Porter Joplin
Page Lawrence
W. R. Mackenzie
Overton S. Meldrum
Waldron H. Rand
Ernest Reckitt
F. A. Ross
John R. Ruckstell
W. Ernest Seatree
W. A. Smith
Edward L. Suffern
C. M. Williams
William Jeffers Wilson

Carl H. Nau was unanimously elected chairman of the council.

A. P. Richardson was unanimously elected secretary of the institute for the current fiscal year.

A. P. Richardson was elected secretary of the council and secretary of all committees, standing and special, for the current fiscal year.

The following nominations for members of the executive committee were made:

Hamilton S. Corwin
W. Sanders Davies
John B. Niven
T. Edward Ross
E. W. Sells

It was moved and seconded that these members be elected members of the executive committee.

The motion was unanimously adopted.

It was moved that the following be elected members of the committee on professional ethics for the current fiscal year:

F. F. White
J. D. M. Crockett
John F. Forbes
J. Porter Joplin
J. E. Masters

The motion was uanimously adopted.

John F. Forbes, Charles E. Mather and Waldron H. Rand were nominated as members of the board of examiners for the term of three years to fill the vacancies caused by the expiration of the terms of Waldron H. Rand, Charles S. Ludlam and H. Ivor Thomas.

The members named were unanimously elected.

It was resolved that the secretary's salary be paid as provided in the budget.

J. S. M. Goodloe asked permission to supplement the report presented by the former committee on state legislation, to the effect that in view of the representations made by the secretary and treasurer of the Oklahoma state board of accountancy, the committee recommend that the council record its approval of the Oklahoma C. P. A. law as at present administered.

The motion was seconded.

The following substitute motion was made:

Resolved, that the negotiations sought to be undertaken by the Oklahoma board of accountancy be referred first to the board of examiners of the institute for approval, and the board of examiners be instructed to report immediately to the executive committee, to which is given power to act on behalf of the council in recognition of the present administration of the Oklahoma law as satisfactory to the institute.

The substitute motion was adopted.

It was moved, in view of the statement of the executive committee that donations to the endowment fund had been disallowed as donations in computing taxable net income, and in view of a further statement from the commissioner of internal revenue in a letter to the secretary that he held such donations to the endowment fund of the institute as not deductible, that the matter be referred to the executive committee with full power to act, whether that action be in the nature of causing a new corporation to be formed to carry on the work of the endowment fund or such other steps as may seem advisable.

The motion was adopted.

It was resolved that a committee be appointed by the president to consider the matter of propaganda in regard to the value of accounting services, and that such committee be requested to collect as far as practicable advertising matter issued by accounting firms and individual accountants, and to have such matter reproduced and copies sent to all members of the institute, so that at the time of the next annual meeting members could come with a definite notion of the question of advertising which would be under discussion at that time.

The motion was adopted.

The chair appointed Arthur W. Teele, John F. Forbes, J. E. Sterrett and W. Sanders Davies members of the committee.

It was resolved that the sum of $500.00 should be appropriated for the use of the committee.

It was resolved that the name of the committee should be the special committee on professional advancement.

The meeting adjourned sine die.

Income-tax Department

EDITED BY STEPHEN G. RUSK

There have been many treasury decisions accumulated since the last issue of THE JOURNAL OF ACCOUNTANCY, and the subject matter is so varied and interesting that we recommend for them a careful reading. Because of the number and the amount of space that the publication of these decisions will occupy we refrain from comment thereon, except to point out a few of special interest.

Treasury decision No. 3050 is especially interesting, and should have careful consideration by accountants in states that have enacted inheritance-tax laws, for it sets forth succinctly why inheritance taxes are not deductible in computing federal income taxes.

Stock dividends, as distinguished from cash dividends, are the subject matter of treasury decision No. 3052.

Rules are laid down in treasury decision 3058 for the inventorying of merchandise by dry-goods dealers.

The above-mentioned decisions, together with those treating of depletion of combined oil and gas wells and various other matters, will be found well worth a few hours' time of any one whose opinion is sought upon income-tax matters.

(T. D. 3047, July 24, 1920)

Income tax

Section 203, revenue act of 1918—Inventories at market—Regulations No. 45 amended

Article 1584, regulations No. 45, is hereby amended to read as follows:

ART. 1584. *Inventories at market*—Market means the current bid price prevailing at the date of the inventory for the particular merchandise, and is applicable to goods purchased and on hand and to basic materials in goods in process of manufacture and in finished goods on hand, exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts at fixed prices entered into before the date of the inventory, *which goods must be inventoried at cost.* Where no open-market quotations are available the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available to him, such as specific transactions in reasonable volume entered into in good faith, or compensation paid for cancellation of contracts for purchase commitments. The burden of proof will rest upon the taxpayer in each case to satisfy the commissioner of the correctness of the prices adopted. It is recognized that in the latter part of 1918, by reason among other things of governmental control not having been relinquished, conditions were abnormal and in many commodities there was no such scale of trading as to establish a free market. In such a case, when a market has been established during the succeeding year, a claim may be filed for any loss sustained in accordance with the provisions of section 214 (*a*) (12) or section 234 (*a*) (14) of the statute. See articles 261-268.

(T. D. 3048, July 26, 1920)

Income tax—Decision of court

Interest which accrued prior to 1909 and was paid in 1911 was not income within the provisions of the excise tax law of 1909.

The appended decision of the United States district court of Minnesota, handed down in March, 1920, in the case of *Northern Pacific Railway Co., plaintiff, v. Lynch, collector,* is published for the information of internal revenue officers and others concerned.

District court of the United States of the district of Minnesota. No. 1005 Northern Pacific Railway Co., plaintiff, v. Edward J. Lynch, collector of internal revenue, defendant

Pursuant to stipulation of the parties waiving a jury duly filed, this case comes on for hearing before the undersigned without a jury at St. Paul on the 22d day of March, 1920, Charles W. Bunn appearing for the plaintiff and Alfred Jaques for the defendant.

The court, having heard the parties, finds as facts:

1. The item, interest on advances to Spokane, Portland & Seattle Railway Co. ($1,603,707.50), was interest accrued before January 1, 1909, on advances which the plaintiff made for construction of the railway of the Spokane, Portland & Seattle Railway Co. This railway was a joint enterprise of the plaintiff and the Great Northern Railway Co., and its construction was provided for in an agreement between the Northern Pacific Railway Co. and the Great Northern Railway Co., made on the 1st day of January, 1908, and a further agreement contemporaneously made between the said two railway companies and the Spokane, Portland & Seattle Railway Co., dated on the same day. It was specially agreed in said contracts that advances of money made by either the Northern Pacific Railway Co. or Great Northern Railway Co. for carrying on the said joint enterprise should be repaid with interest at the rate of 5 per cent per annum from the time of making each advance. These advances commenced on or about the date of said contracts and continued until some time in the year 1911. The interest accruing on the advances was not entered up either on plaintiff's books or of those of the Spokane, Portland & Seattle Railway Co. until the construction work was completed in 1911, when the advances made by the Northern Pacific Railway Co. with interest were repaid by the Spokane, Portland & Seattle Railway Co. according to the terms of said contract. The item of interest in question is the amount of interest which accrued on said advances prior to the 1st of January, 1909, and which was settled and paid in the year 1911.

2. The plaintiff on the trial abandoned the claim made in the complaint on account of the item of $263.18.

3. The other item included in this suit was definitely ascertained and vested in the plaintiff before the 1st day of January, 1909, and were on that day the property of the plaintiff.

The court directs judgment in favor of the plaintiff against the defendant in the sum of $16,040.98, together with interest at the rate of 6 per cent from the 12th day of September, 1917, the date of plaintiff's payment to defendant under protest.

(T. D. 3049, July 27, 1920)

Income tax—Compensation of federal judges—Opinion of the attorney general

The compensation of a judge of the supreme court or of an inferior court of the United States is subject to a statute imposing an income tax enacted before his term of office begins.

In the case of *Evans v. Gore* (T. D. 3037 of June 21, 1920), the supreme court held that salaries of federal judges, appointed before the incidence of the revenue act of 1918, are not subject to payment of income tax thereunder. The attorney general, in response to a request from the secretary of the treasury, has advised that the salary of a federal judge may be subjected to a federal income tax where the act imposing such tax is passed prior to the time the judge in question took office. A copy of the opinion of the acting attorney general is published herewith for your information.

This office will be governed by the opinion of the acting attorney general.

DEPARTMENT OF JUSTICE

WASHINGTON, June 21, 1920.

DEAR MR. SECRETARY: I have the honor to acknowledge receipt of your request to be advised whether, in view of the supreme court's decision in the case of *Evans v. Gore*, to refrain from the collection of income taxes under the revenue act of 1918 from judges and the president taking office after the passage of the act, as well as from those in office when the law was passed.

In the opinion of the solicitor accompanying your request certain quotations are made from the opinion of the court in the case above referred to as indicating that the court intended to hold that the salary of no federal judge could constitutionally be included in his taxable income regardless of whether he became a judge before or after the passage of the act. I do not think, however, that anything that was said in that opinion can fairly bear this construction. That question was not before the court. The judge then contesting the constitutionality of the law was appointed many years ago, and the rights of one appointed subsequent to the enactment of the law were in nowise involved. The only question was whether the requirement that a judge's salary should be included in his taxable income was, within the meaning of the constitution, a diminution of his compensation as it had been fixed by act of congress prior to the enactment of this tax law. Congress has the same power to fix the compensation of judges that it has to levy taxes, except that it has no power during the term of office of a judge to fix his compensation at a sum less than it was when he became a judge.

The effect of the recent decision is to hold that the levying of a tax upon the compensation thus fixed is a diminution of that compensation in the constitutional sense. In fixing the compensation, however, which judges hereafter appointed shall receive, there is no limitation upon the power of congress. It may fix the compensation of such judges at a figure less than that now received by judges of the same rank, and which the latter will be entitled to receive during the remainder of their service. In fixing such compensation, I see no reason why congress may not say that the compensation shall be a certain amount less a fixed percentage thereof which shall be paid or retained as an income tax. When, therefore, after the salary of the judges has been fixed by law and another act has been passed making those salaries subject to a fixed and definite income tax, a judge who is appointed takes his office with his actual compensation fixed at the amount of the salary less the amount of income tax. Upon assuming the duties of the office he is entitled to receive no more than this; and when he pays the tax previously fixed by law there has been no diminution of the compensation to which he was entitled at the beginning of his term of service. I am unable to see, therefore, that there is anything in the recent opinion of the supreme court which relieves a judge appointed since the enactment of the income-tax law from paying the tax imposed by that law.

Respectfully,

WILLIAM L. FRIERSON,
Acting Attorney General.

HON. DAVID F. HOUSTON,
Secretary of the Treasury, Washington, D. C.

(T. D. 3050, July 27, 1920)

Income tax—Decision of court

Deductibility of New York inheritance tax in computing income of legatee.

The tax imposed by the state of New York on the transfer of decedent's estate is a tax on the right of disposition of the property, and is not a tax on the privilege of the legatee to receive it. Therefore in computing the net income of the legatee subject to the income tax the New York inheritance tax is not a proper deduction from gross income under the provisions of section 2, paragraph B, act of October 3, 1913.

The appended decision of the United States circuit court of appeals for the second district in the case of *Elizabeth S. Prentiss v. Mark Eisner, collector,* third district of New York, affirming the judgment of the lower court (260 Fed., 589, T. D. 2933), is published for the information of internal-revenue officers and others concerned.

United States Circuit Court of Appeals for the Second Circuit

Elizabeth S. Prentiss, plaintiff in error (plaintiff below), v. Mark Eisner, collector of internal revenue, third district of New York, defendant in error (defendant below).

Before Rogers, Hough and Manton, circuit judges

This cause comes here on writ of error to the United States district court for the southern district of New York.

The facts are stated in the opinion.

Rogers, circuit judge: This is an action to recover from the defendant the sum of $7,432.88 with interest, which amount the plaintiff alleges she was wrongfully compelled to pay to the defendant as collector of internal revenue.

It appears that the plaintiff and her then husband, since deceased, filed with the defendant a joint return of their net income for the year 1913, pursuant to the act of congress approved October 3, 1913 (U. S. Stat. L., vol. 38, pt. 1, ch. 16, Sec. II, p. 166).

The aforesaid act of congress, in paragraph B, page 167, provided as follows:

That, subject only to such exemptions and deductions as hereinafter allowed, the net income of a taxable person shall include gains, profits and income, including * * * but not the value of property acquired by gift, bequest, devise, or descent. * * *

That in computing the net income for the purpose of the normal taxes there shall be allowed as payment; * * * third, all national, state, county, school and municipal taxes paid within the year, not including those assessed against local benefits.

And in paragraph D, page 168, it provided as follows:

The said tax shall be computed upon the remainder of said net income of each person subject thereto accruing during each preceding calendar year ending December thirty-first: *provided, however,* That for the year ending December thirty-first, nineteen hundred and thirteen, said tax shall be computed on the net income accruing from March first to December thirty-first, nineteen hundred and thirteen, both dates inclusive, after deducting five-sixths only of the specific exemptions and deductions herein provided for.

It appears, too, that in the year 1913 the plaintiff inherited a portion of her father's estate, and that on the inheritance thus received by her the state of New York assessed against her an inheritance tax of $259,805.71, which amount she paid on December 11, 1913.

The plaintiff in making her income return under the act of congress included therein as a deduction five-sixths of the inheritance tax which she had

paid to the state of New York, which amounted to $216,504.75. This deduction was not allowed by the commissioner of internal revenue, and he levied and assessed against her an additional tax of $7,432.88. Thereupon she instituted this action to recover back the amount so paid.

The complaint was demurred to upon the ground that it did not state facts sufficient to constitute a cause of action. The court below sustained the demurrer and dismissed the complaint.

The question of law thus presented is whether the payment by the plaintiff of the inheritance tax to the state of New York was a proper deduction from her income tax return for the year 1913. That is the sole question herein involved. The plaintiff's contention is that the inheritance tax which she paid to the state of New York was a tax paid to a state, and therefore under the act of congress the plaintiff was entitled to make the deduction of five-sixths of the amount so paid in making her income return.

The commissioner of internal revenue in making the ruling to which reference has been made stated that—

A collateral inheritance tax levied under the laws of the state of New York being, as it is, a charge against the corpus of the estate, does not constitute such an item as can be allowed as a deduction in computing income tax liability to either the estate or beneficiary thereof.

The district judge in sustaining the demurrer states that he did not regard the New York transfer tax "as imposing a tax upon the plaintiff's right of succession which is deductible in her income tax return."

Material provisions of the New York transfer tax act may be found in the margin.

The New York act reads as follows in section 220 of Article X:

A tax shall be and is hereby imposed upon the transfer of * * * property * * * to persons or corporations in the following cases * * * : (1) When the transfer is by will or by the interstate laws of this state * * * (4) when the transfer is by deed * * * intended to take effect in possession or enjoyment at or after such death. * * * The tax imposed hereby shall be upon the clear market value of such property at the rates hereinafter prescribed.

Section 224 reads as follows:

Lien of tax and collection by executors, administrators and trustees.— Every such tax shall be and remain a lien upon the property transferred until paid, and the person to whom the property is so transferred, and the executors, administrators, and trustees of every estate so transferred shall be personally liable for such tax until its payment. Every executor, administrator or trustee shall have full power to sell so much of the property of the decedent as will enable him to pay such tax in the same manner as he might be entitled by law to do for the payment of the debts of the testator or intestate. Any such executor, administrator or trustee having in charge or in trust any legacy or property for distribution subject to such tax shall deduct the tax therefrom and shall pay over the same to the state comptroller or county treasurer, as herein provided. If such legacy or property be not in money, he shall collect the tax thereon upon the appraised value thereof from the person entitled thereto. He shall not deliver or be compelled to deliver any specific legacy or property subject to tax under this article to any person until he shall have collected the tax thereon. If any such legacy shall be charged upon or payable out of real property, the heir or devisee shall deduct such tax therefrom and pay it to the executor, administrator or trustee, and the tax shall remain a lien or charge on such real property until paid; and the payment thereof shall be enforced by the executor, administrator or trustee, in the same manner that payment of the legacy might be enforced, or by the district attorney under section two hundred and thirty-five of this

chapter. If any such legacy shall be given in money to any such person for a limited period, the executor, administrator or trustee shall retain the tax upon the whole amount, but if it be not in money, he shall make application to the court having jurisdiction of an accounting by him, to make an apportionment, if the case require it, of the sum to be paid into his hands by such legatee, and for such further order relative thereto as the case may require.

The right to dispose of property by will is statutory. The matter has always been recognized as within the legislative control. In the reign of Henry II (1154-1189) a man's personal property was, at his death, divided into three equal parts, if he died leaving a wife and children: One part went to his wife, another to his children, and only the remaining third could be disposed of by his will. And, at least after the establishment of the feudal system and prior to the enactment of the statute of wills (32 Henry VIII), the right to make a will of real estate was not known to the English law.

There has been and still is a difference of opinion among the courts as to the exact nature of an inheritance tax. It is generally agreed that such a tax is not upon the property or money bequeathed. The dispute is over the question whether the tax is laid on the privilege of receiving the property so transmitted. The right to transmit and the right to receive are distinct, and each is alike under the legislative control. The distinction between the right to transmit and the right to receive is important, and upon the distinction depends the right to deduct or not to deduct the amount of the tax in the income return submitted to the federal government.

The circuit court of appeals in the third circuit has recently decided *Lederer v. Northern Trust Co.* (262 Fed., 52). In that case the question arose as to the right to deduct a tax paid under the collateral inheritance tax act in the state of Pennsylvania. The answer to be given to that question depended upon whether the Pennsylvania tax was an estate tax, the burden of which was imposed upon the estate of a decedent as claimed by the executors, or was a legacy tax, the burden of which was imposed upon the legatee or beneficiary. It happened that the supreme court of Pennsylvania in *Jackson v. Myers* (257 Pa., 104) had squarely decided that the collateral inheritance tax of that state was not levied upon an inheritance or legacy, but upon the estate of the decedent, and had held that what passed to the legatee was simply the portion of the estate remaining after the state had been satisfied by receiving the tax. The circuit court of appeals held that the decision of the supreme court of Pennsylvania construing the inheritance tax law of that state was binding on the federal courts, and that inasmuch as the tax was held by that court as a tax on the estate and not a tax on the inheritance, the amount of the tax so paid was properly deductible in computing the net estate under the act of congress of September 8, 1916. Under a like state of facts we should have no difficulty in reaching a like conclusion. But the case with which we are dealing presents a different question, involving, as it does, the tax law not of Pennsylvania but of New York.

In 1900 the supreme court in *Knowlton v. Moore* (178 U. S., 41) had under consideration a tax imposed under the war revenue act of June 13, 1898 (20 Stat., 448). The opinion in that case is exhaustive and occupies about 70 pages. It deals with the subject of death duties and sustains the constitutional right of congress to impose death duties. In the course of the opinion, which was written by Justice (now Chief Justice) White, it was said:

Thus, looking over the whole field, and considering death duties in the order in which we have reviewed them, that is, in the Roman and ancient law; in that of modern France, Germany and other continental countries; in England and those of her colonies where such laws have been enacted,

in the legislation of the United States and the several states of the Union—the following appears: Although different modes of assessing such duties prevail, and although they have different accidental names, such as probate duties, stamp duties, taxes on the transaction, or the act of passing of an estate or a succession, legacy taxes, estate taxes, or privilege taxes, nevertheless tax laws of this nature in all countries rest in their essence upon the principle that death is the generating source from which the particular taxing power takes its being, and that it is the power to transmit, or the transmission from the dead to the living, on which such taxes are more immediately rested.

It thus appears, as the opinion of the court, that in general death duties are imposed on the power to transmit. However, the immediate question with which we are now concerned is whether the so-called tax which the New York law has imposed, and which is herein involved, is a tax upon the power to transmit or is laid on the power to receive. In 1889 a testator within the state of New York died and devised and bequested all his estate,—both real and personal, to the government of the United States. The surrogate's court imposed an inheritance tax upon the personal property. The case was taken on appeal to the general term of the supreme court of New York and later to the New York court of appeals, by each of which it was affirmed. It was then taken to the supreme court of the United States, by which it was in like manner affirmed. The question was whether the personal property bequeathed to the United States was subject to an inheritance tax under the laws of New York. The supreme court held the property to be subject to the tax. (*United States v. Perkins,* 163 U. S., 625.) In the course of its opinion the court said: "In this view the so-called inheritance tax of the state of New York is in reality a limitation upon the power of a testator to bequeath his property to whom he pleased; a declaration that, in the exercise of that power, he shall contribute a certain percentage to the public use; in other words, that the right to dispose of his property by will shall remain, but subject to a condition that the state has a right to impose. Certainly, if it be true that the right of testamentary disposition is purely statutory, the state has a right to require a contribution to the public treasury before the bequest shall take effect. Thus the tax is not upon property, in the ordinary sense of the term, but upon the right to dispose of it, and it is not until it has yielded its contribution to the state that it becomes the property of the legatee." And the court went on to say: "That the tax is not a tax upon the property itself, but upon its transmission by will or by descent, is also held both in New York and in several other states." We find no case in the subsequent decisions of the New York court of appeals in which that court disclaims the construction placed by the supreme court of the United States on the New York decisions, or in any way qualifies or overrules the proposition that the "tax" under the New York law is not one upon the property, but is one upon the right to dispose of it by will or by descent. In the absence of such a decision it seems to be our duty to follow the law as it is laid down in the Perkins case unless there can be found in the New York statute in force, when the present tax was laid, some substantial difference from the statute in force when that case was decided in the particular now being considered. If such a difference exists we have failed to detect it, and learned counsel have failed to point out in what it consists.

The New York court of appeals in 1919 in matter of Watson, 226 N. Y., 384, 399, the court, in discussing a provision in the New York inheritance tax law imposing tax upon the transfer of property at the time of death which had not theretofore paid any tax, local or state, said: "The beneficiary has no claim to the property of an ancestor except as given by law, and, if the state has a right to impose a tax at all upon the passing of property, the transferee takes only what is left after the tax is paid." The opinion quotes

at page 396 from the opinion of the supreme court of the United States in the matter of Penfield, 216 N. Y., 163, 167 (1915), that under the New York law the inheritance tax is not upon the property but upon the right to dispose of it. There is not one word of criticism, not one word of dissent, and not the slightest suggestion of disapproval of that proposition anywhere in the opinion.

In matter of Penfield, supra, the New York court declares what it had several times before stated that "the transfer tax is not a tax upon property, but upon the right of succession to property." The language of the statute is that the tax is "due and payable at the time of the transfer"; that is, at the death of the decedent. It accrues at that time.

Now a succession tax is a tax upon a transfer of property in general, and as such is distinguishable from a legacy duty, which is a tax upon a specific bequest. Under the New York law the succession tax creates a lien upon the estate of the decedent at the moment of his death. The right of the state to the amount of this lien attaches at that time and it must be paid before the transferee, legatee or devisee ever gets anything, and the executor or administrator is personally liable for the tax until it has been paid. Under such a law we do not see that the transferee pays the tax. In stating this conclusion we have not overlooked what was said in the matter of Gihon, 169 N. Y., 443, 447, where it is said that "though the administrator or executor is required to pay the tax, he pays it out of the legacy for the legatee, not on account of the estate. The requirement of the statute that the executor or administrator shall make the payment is prescribed to secure such payment, because the government is unwilling to trust solely to the legatee." The fact, however, remains that if a legacy left by a will is $10,000, and the executor has paid to the state on its account a tax of $500, and then has turned over to the legatee $9,500, the legatee has received not $10,000 but $9,500, and the legatee has been enriched only to the extent of the amount which he has himself received, and he has not paid the tax nor has it been paid by his authority, nor by anyone representing him. The payment has been made by the personal representative of the deceased, and in making it he has acted under authority of the statute.

As was said by Judge Gray in matter of Swift, 137 N. Y., 77, "What has the state done, in effect, by the enactment of this tax law? It reaches out and appropriates for its use a portion of the property at the moment of its owner's decease; allowing only the balance to pass in the way directed by the testator, or permitted by its intestate law."

We admit that the New York cases on the subject of taxable transfers are confused and not always clear and consistent. But until the New York court of appeals authoritatively states that the law of New York is not what the supreme court of the United States said it was in the Perkins case, this court has no alternative but to hold that the New York transfer act does not impose a tax on a legatee's right of succession which is deductible in her income tax return. The legacy which the plaintiff herein received under the will of her father did not become her property until after it had suffered a diminution to the amount of the tax, and the tax that was paid thereon was not a tax paid out of the plaintiff's individual estate but was a payment out of the estate of her deceased father of that part of his estate which the state of New York had appropriated to itself, which payment was the condition precedent to the allowance by the State of the vesting of the remainder in the legatee.

Judgment affirmed.

(T. D. 3051, July 27, 1920)

War excess profits tax—Title II, act of October 3, 1917—Decision of Court

1. Invested Capital

The act of 1917 undertakes to define "invested capital," and in com-

puting invested capital it is necessary to come within the definition contained in the act.

2. Invested Capital

Appreciation of capital assets not realized by sale cannot be included in the computation of invested capital.

3. Statutory Construction

Inequalities in a valid taxing act arising in the application to a particular case cannot be corrected by judicial construction.

4. Statutory Construction

Where the act is ambiguous the construction of the administrative officers charged with its execution is entitled to great respect.

The appended memorandum decision of the United States court of claims in the case of *La Belle Iron Works, petitioner, v. the United States* is published for the information of internal revenue officers and others concerned.

Note:—In order that the opinion of the court in the case may be more clearly understood it may be desirable to state briefly the material facts, as set out in plaintiff's petition.

STATEMENT OF FACTS

Plaintiff is a West Virginia corporation. Prior to the year 1904 the corporation acquired certain ore lands, paying therefor the sum of $190,000. After the said ore lands were so acquired extensive explorations were carried on, and it was proved that said lands contained large bodies of ore. Between the date of purchase and the year 1912 the lands greatly increased in value. In the year 1912 the actual cash value of said lands was not less than $10,105,400, and at all times during the years 1912 to 1917 the actual value of the lands in question was not less than $10,105,400. In the year 1912 the corporation increased the valuation of said lands on its books by adding thereto the sum of $10,000,000, and carried such last-mentioned sum to surplus. Thereupon in said year 1912 the corporation declared a stock dividend in the sum of $9,115,400, representing the increase in value of said lands. At that time the old stock in the corporation was surrendered by the shareholders and new stock including the stock dividend was issued. In the year 1917 the petitioner included the sum representing the increased value of its lands in the computation of its invested capital for the purpose of determining the amount of its excess profits taxes. The commissioner refused to allow the corporation to include the said sum of $9,915,400 in computing its invested capital for the year 1917. Accordingly, said sum was stricken from the corporation's invested capital, which was thereby reduced from $26,322,907.14 to $16,407,507.14. The direct result of so reducing the invested capital of the corporation was an additional excess profits tax of $1,081,184.61, which was paid under protest. Claim for refund was duly rejected. Plaintiff thereupon brought the suit in question for the purpose of recovering said sum of $1,081,184.61, alleging it to have been unlawfuly collected.

Plaintiff alleged that the appreciated value of its ore lands was "tangible property paid in for stock"—that it was also "earned surplus used or employed in the business," and therefore came within the definition of invested capital in the revenue act of 1917. Plaintiff further contended that the construction given to the act by the government resulted in inequalities and was therefore erroneous.

The following is the order of the court dismissing the petition and memorandum therewith:

COURT OF CLAIMS OF THE UNITED STATES. No. 34603
(Decided June 28, 1920)

La Belle Iron Works, a corporation, v. United States

This cause coming on to be heard was submitted to the court—three judges sitting—upon the defendant's demurrer to the plaintiff's petition, as amended, and was argued by counsel. On consideration whereof, the court is of the opinion that the demurrer is well taken. It is therefore adjudged and ordered that the defendant's demurrer to the petition so amended in this cause be, and the same is hereby, sustained and the petition as amended is dismissed.

MEMORANDUM

The court's conclusions are:

(1) That the act in question (40 Stat., 306) undertakes to define "invested capital," and the averments of the petition cannot be said to bring the plaintiff's case within the definition of section 207.

(2) That the increase in value of plaintiff's ore lands, which was first declared to be surplus, and afterwards treated as the basis of a stock dividend, did not thereby become earned surplus or individual profits or invested capital within the meaning of the act of 1917. The stock dividend added nothing to, and took nothing from, the corporation's invested capital.

(3) That the inequalities, which can arise in the application of the statute to particular cases, cannot be corrected by judicial construction, where the enactment is otherwise valid.

(4) That where the act is ambiguous or uncertain, the construction of it by the administrative officers charged with its execution is entitled to great respect.

(T. D. 3052, August 4, 1920)

Income tax

Stock dividends—Some applications of the decision of the supreme court of the United States in the case of *Eisner v. Macomber,* rendered March 8, 1920, in the determination of the taxability of dividends.

The following applications of the decision of the supreme court of the United States in the case of *Eisner v. Macomber* in the determination of the taxability of dividends declared by corporations are published for the information and guidance of internal revenue officers and others concerned:

1. Where a corporation, being authorized so to do by the laws of the state in which it is incorporated, transfers a portion of its surplus to capital account, issues new stock representing the amount of the surplus so transferred, and distributes the stock so issued to its stockholders, such stock is not income to the stockholders, and the stockholders incur no liability for income tax by reason of its receipt.

2. Where a corporation, being thereunto lawfully authorized, increases its capital stock, and simultaneously declares a cash dividend equal in amount to the increase in its capital stock, and gives to its stockholders a real option either to keep the money for their own or to reinvest it in the new shares, such dividend is a cash dividend and is income to the stockholders whether they reinvest it in the new shares or not.

3. Where a corporation, which is not permitted under the laws of the state in which it is incorporated to issue a stock dividend, increases its capital stock, and at the same time declares a cash dividend under an agreement with the stockholders to reinvest the money so received in the new issue of capital stock, such dividend is subject to tax as income to the stockholder.

4. Where a corporation, having a surplus accumulated in part prior to

March 1, 1913, and being thereunto lawfully authorized, transfers to its capital account a portion of its surplus, issues new stock representing the amount so transferred to the capital account, and then declares a dividend payable in part in cash and in part in shares of the new issue of stock, that portion of the dividend paid in cash will, to the amount of the surplus accumulated since March 1, 1913, be deemed to have been paid out of such surplus, and be subject to tax, but the portion of the dividend paid in stock will not be subject to tax as income.

5. A dividend, paid in stock of another corporation held as a part of the assets of the corporation paying the dividend, is income to the stockholder at the time the same is made available for distribution to the full amount of the then market value of such stock (*Peabody v. Eisner*, 247 U. S., 347); and if such stock be subsequently sold by the stockholder, the difference between its market value at date of receipt and the price for which it is sold is additional income or loss to him, as the case may be.

6. The profit derived by a stockholder upon the sale of stock received as a dividend is income to the stockholder, and taxable as such even though the stock itself was not income at the time of its receipt by the stockholder. For the purpose of determining the amount of gain or loss derived from the sale of stock received as a dividend, or of the stock with respect to which such dividend was paid, the cost of each share of stock (provided both the dividend stock and the stock with respect to which it is issued have the same rights and preferences) is the quotient of the cost of the old stock (or its fair market value as of March 1, 1913, if acquired prior to that date), divided by the total number of shares of the old and new stock.

(T. D. 3053, August 10, 1920)

Income tax

Gross income of life insurance companies—Article 549 of regulations No. 45, amended

Article 549 of regulations No. 45 is hereby amended to read as follows:

ART. 549. Gross income of life insurance companies.—A life insurance company shall not include in gross income such portion of any actual premium received from any individual policyholder as is paid back or credited to or treated as an abatement of premium of such policyholder within the taxable year. (*a*) "Paid back" means paid in cash. (*b*) "Credited to" means applied by way of credit to the payment of the premium for the taxable year. It does not include dividends applied to purchase additional paid-up insurance or annuities, or to shorten the endowment or premium paying period, or in any way that does not actually reduce the premium receipts of the company for the taxable year. (*c*) "Treated as an abatement of premium" means of the premium for the taxable year. Where the dividend paid back is in excess of the premium received from the policyholder within the taxable year there may be excluded from gross income only the amount of such premium received, and where no premium is received from the policyholder within the taxable year the company is not entitled to exclude from its premiums received from other policyholders any amount in respect of such dividend payment.

(T. D. 3055, August 12, 1920)

Income tax

Computation of depletion allowance for combined holdings of oil and gas wells—Article 214, regulations No. 45, amended. Article 214 of regulations No. 45 is hereby amended to read as follows:

ART. 214. *Computation of depletion allowance for combined holdings of oil and gas wells.*—(1) The recoverable oil belonging to the taxpayer shall be

estimated for each property separately. The capital account for each property shall include the cost of value, as the case may be, of the oil or gas lease or rights, plus all incidental costs or development not charged as expense nor returnable through depreciation. The unit value of the recoverable oil or gas for each property is the quotient obtained by dividing the capital account recoverable through depletion for each property by the estimated number of units of recoverable oil or gas on that property. This unit for each separate property multiplied by the number of units of oil or gas produced within the year by the taxpayer upon such property will determine the amount which may be deducted for depletion from the gross income of that year for that property. The total allowance for depletion of all the oil or gas properties of the taxpayer will be the sum of the amounts computed for each property separately: provided,

(2) That in the case of gas properties the depletion allowance for each pool may be computed by using the combined capital accounts returnable through depletion of all the tracts of gas land owned by the taxpayer in the pool and the average decline in rock pressure of all the taxpayer's wells in such pool in the formula given in article 211. The total allowance for depletion in the gas properties of the taxpayer will be the sum of the amounts computed for each pool.

(T. D. 3056, August 14, 1920)

Income tax

Concerning the creation of a sinking fund by a corporation in order to secure the payment of its bonds or other indebtedness

The final edition of regulations No. 45 is amended by inserting immediately after article 541 a paragraph, to be known as article 541 (*a*), as follows:

Art. 541 (*a*). *Creation of sinking fund.*—If a corporation, in order solely to secure the payment of its bonds or other indebtedness, places property in trust, or sets aside certain amounts in a sinking fund under the control of a trustee, who may be authorized to invest and reinvest such sums from time to time, the property or fund thus set aside by the corporation and held by the trustee is an asset of the corporation, and any gain arising therefrom is income of the corporation and shall be included as such in its annual return. The trustee, however, is not taxable as such on account of the property or fund so held. (See sec. 219 and arts. 341 to 347.) If such fund is invested by the trustee in whole or in part in bonds, the trustee when presenting coupons from the bonds for payment shall file ownership certificates (form 1001 revised), whether or not the bonds contain a tax-free covenant clause. (See art. 366.)

(T. D. 3057)

Corporation excise tax—Act of August 5, 1909—Decision of court

1. Mutual Life Insurance Company—Income Received During the Year—Surplus—Dividends

In the case of a mutual life insurance company, transacting business on the level-premium plan, the surplus out of which dividends are paid in any year consists of the ascertained over-payments of premiums for the preceding year. Therefore, surplus for the year 1909 was received prior to the time the act became effective, and dividends paid out of such surplus and applied, at the option of the policyholder, to purchase paid-up additions and annuities or in partial payment of renewal premiums, were not income for the year in which they were applied. The surplus from premiums out of which the dividends for the year 1910 were declared was a part of the income for the

1909, and formed a basis for taxation for that year. *Maryland Casualty Co. v. United States,* 251 U. S., 342, distinguished.

2. Deferred Premiums—Accrued Interest—Income When Received

Premiums due and deferred and interest due and accrued but not actually collected in cash within the taxable year are not income "received."

3. Interest on Policy Loans—Income When Paid

Interest on policy loans, which by the terms of the contract was added to the principal when it became due, does not constitute income where it remains unpaid by the policyholder.

4. Deductions—Amortization of Bonds—Depreciation

Decrease in the value of assets of an insurance company through amortization of premiums on bonds are mere book adjustments and are not deductible as an item of depreciation.

5. Deductions—Net Addition to Reserve—Definition

The reserve funds, the net addition to which is to be deducted from the gross income of a life insurance company in computing its net income, are those funds which are built up to mature the policy, and do not include funds reserved, because of liabilities on supplementary contracts not involving life contingencies and canceled policies upon which a cash-surrender value may be demanded.

6. Judgment Modified

The judgment of the district court (248 Fed., 568) modified.

The appended decision of the United States circuit court of appeals for the seventh circuit in the case of *Henry Fink, collector, etc., v. Northwestern Mutual Life Insurance Co.,* is published for the information of internal revenue officers and others concerned.

United States Circuit Court of Appeals for the Seventh Circuit.
No. 2675

(October term, 1919; April session, 1920)

Henry Fink, collector of internal revenue for the eastern district of Wisconsin, plaintiff in error, v. Northwestern Mutual Life Insurance Co., defendant in error

Appeal from the district court for the eastern district of Wisconsin

[June, 1920]

Before Baker, Evans and Page, circuit judges

Page, circuit judge: This case comes here on a writ of error to reverse the judgment for plaintiff in the district court, entered by Judge Geiger (see 248 Fed., 568, where the facts are fully stated). The insurance company, the defendant in error, will herein be known as plaintiff and the collector of internal revenue, plaintiff in error, will herein be known as defendant.

The commissioner of internal revenue amended plaintiff's returns of income for the years 1909 and 1910, filed under the excise tax law of August 5, 1909, and thereby greatly increased the tax. This suit was brought to recover that increase, paid under protest.

Defendant states the following as the questions involved, and they will be determined as written:

I

1. Whether dividends applied at the option of the policyholders to purchase paid-up additions and annuities were not income for the year in which so applied within the meaning of the act.

2. Whether dividends applied at the option of the policyholders in partial payment of renewal premiums were not income for the year in which so applied within the meaning of the act.

The excise tax act of August 5, 1909 (36 Stats. L., ch. 6, p. 11 (112), provides:

* * * Every insurance company * * * organized under the laws * * * of any state * * * shall be subject to pay annually a special excise tax * * * equivalent to one per centum upon the entire net income over and above $5,000 *received by it from all sources during such year,* exclusive, etc. * * * Such net income shall be ascertained by deducting from the gross amount of the income of such * * * insurance company, *received within the year from all sources,* * * * (second) * * * and in the case of insurance companies the sum other than dividends, paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve funds;

Disregarding the deductions, the basis for the tax is "income * * * received * * * *during such year.*"

Plaintiff is a mutual insurance company, organized under the laws of Wisconsin, and annually collects level premiums which are sufficiently large to pay the insurance cost, including reserves, and all of the expenses of the business. Usually there is something left over for a surplus, which surplus is required by the laws of the State of Wisconsin to be divided among the policyholders. The dividend of surplus is in no sense a dividend of profits. By dividing such a surplus by means of the so-called "dividend," the company simply says to its policyholders: "There is available to you, from funds heretofore paid by you to this company, a sum of money that may be used by you for the payment of premiums, paid-up additions, annuities, or for whatever use you may choose to make of it."

The excise law did not take effect until January 1, 1909, and, inasmuch as the surplus converted into dividends in 1909 was received by the company before the law went into effect, that surplus, converted into dividends, was not income for 1909. The surplus from premiums, out of which the dividends for 1910 were declared, was a part of the income for 1909, and formed a basis for taxation, under the excise law, for that year, and could not, as dividends, form a basis for further taxation. In other words, the fair interpretation of the statute is that income forms a basis for taxation only for the year in which it was received. *Herold v. Mutual Benefit Life Ins. Co.*, 201 Fed., 918; *Maryland Casualty Co. v. United States,* decided by the Supreme Court of the United States January 12, 1920; *Hays v. Gauley Mt. Coal Co.,* 247 U. S., 192. There is nothing in *Maryland Casualty Co. v. United States,* supra, out of harmony with this interpretation. It was said that funds of an insurance company, which had escaped taxation in the year in which they were received because they had been set aside as a reserve in that year and therefore had formed no basis for taxation, might, if they were released from that reserve to the general uses of the company, be treated as income for the year in which they were so released.

II

3. Whether premiums due and deferred and interest due and accrued, but not actually collected in cash, were not income within the meaning of the act.

In *Hays v. Gauley Mt. Coal Co.,* supra, this question was answered contrary to the contention of the government in the following language:

The expression "income *received during such year,*" employed in the act of 1909, looks to the time of realization rather than to the period of accrue-

ment, except as the taking effect of the act on a specified date (Jan. 1, 1909), excludes income that accrued before that date.

See also *Maryland Casualty Co. v. United States*, supra.

III

4. Whether interest on policy loans, which by the terms of the contract was added to the principal of the loan when it became due and remained unpaid by the policyholders, was not income within the meaning of the act.

This question is answered contrary to the government's contention by *Board of Assessors, etc., v. New York Life Ins. Co.*, 216 U. S., 517.

IV

5. Whether increases in the value of assets because of accrual of discounts were not income, and decreases in value of assets because of amortization of premiums on bonds were a deduction from income under the act.

In the reassessment the commissioner added to income for the two years a total as "accrual of discount" of $67,268.96, and deducted for "depreciation" (amortization of bonds) for the two years $231,654.86. In his findings of fact, Judge Geiger said:

Plaintiff waived objection in each amended return made by the commissioner of internal revenue to the item "accrual of discount" and to the item "depreciation."

Thereupon the court disposed of those items by deducting the "accrual of discount" from the "depreciation," giving plaintiff a net deduction of $164,385.90. Inasmuch as plaintiff waived objection to items "accrual of discount," the propriety of such a charge will not be discussed here. If deduction by reason of amortization of premiums on bonds was proper, it must have been so under the following provision of the statute, viz.:

All losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any.

There was no sale. The item arose from mere book adjustments. In our opinion amortization of bonds does not come within any definition of "depreciation" under this or similar acts. In considering the excise statute, the supreme court has said:

What was here meant by "depreciation of property?" We think congress used the expression in its ordinary and usual sense as understood by business men. It is common knowledge that business concerns usually keep a depreciation account, in which is charged off the annual losses for wear and tear, and obsolescence of structures, machinery, and personality in use in the business.

The court then said that it did not consider the statute covered a depreciation of a mine by exhaustion of the ores. *Von Baumbach v. Sargent Land Co.*, 242 U. S., 534. See also *Lumber Mut. Fire Ins. Co. v. Malley*, 256 Fed., 383; *Baldwin L. Works v. McCoach*, 221 Fed., 59; *Van Dyke v. Milwaukee*, 159 Wis., 460.

Plaintiff's claim that this question is not within the issues in this case is clearly overborne by its second and eleventh assignments of reasons why the tax is excessive and illegally assessed, viz.:

2. No greater amount of taxes should have been * * * collected * * * for the year 1909 than the sum of $43,729.78, etc.

Number 11 is similar. It seems clear that a suit of this character is for all purposes a contest between the government and the taxpayer, the question being, how much tax should the plaintiff have paid? In *Crocker v. Malley*, 249 U. S., 223, the court found that the tax actually assessed against the

plaintiffs as a joint stock association was improperly assessed and collected because the plaintiffs were not a joint stock association, but simply trustees. At page 235 the court said:

The district court, while it found for the plaintiffs, ruled that the defendant was entitled to retain * * * the amount of the tax that they should have paid as trustees. * * * The commissioner of internal revenue rejected the plaintiffs' claim, and the statute does not leave the matter clear. The recovery, therefore, will be from the United States. (Rev. Stats., sec. 989.) The plaintiffs, as they themselves alleged in their claim, were the persons taxed, whether they were called an association or trustees. They were taxed too much. If the United States retains from the amount received by it the amount that it should have received, it cannot recover that sum in a subsequent suit.

See also *Missouri River, F. S. & G. R. Co. v. United States,* 19 Fed., 67. Plaintiff cites the Eaton cases, 218 Fed., 188. The reason given by the court, in the first case, for allowing items "bonds for accrual of discount" and "bonds for amortization of premiums" is—

Because the testimony shows that the method of annually scaling down the book values of bonds purchased at a premium, and making additions to the book value of bonds purchased below par * * * is in accordance with the law and the requirements of the insurance departments of the different states.

The record here shows no such practice by plaintiff. What law that action was in accordance with the decision does not say, but it certainly was not in accordance with the excise tax act. Whether it was in accordance with the requirements of the insurance departments of the different states makes no difference. The only clause, if any, under the excise law which would permit the commissioner to exercise any influence upon deductions is the following, relating to deductions: "The net addition, if any, required by law to be made within the year to reserve funds." Under authority of *Maryland Casualty Co. v. United States,* supra, the requirement of the insurance commissioner as to reserves would be a thing "required by law."

We are of opinion that decreases in value of assets because of amortization of premiums on bonds were not a proper deduction, and that there should be deducted from the judgment of the court below the sum of $1,643.86, with interest thereon at the rate of 6 per cent from January 22, 1912, to the date of the entry of the original judgment on November 16, 1917.

V

6. Whether an addition to the reserve funds because of liability on supplementary contracts not involving life contingencies and canceled policies upon which a cash surrender value may be demanded was deductible from gross income under the act.

The excise law permits insurance companies to deduct "the net addition, if any, required by law to be made within the year to reserve funds."

Section 1952 of the Wisconsin state law provides:

In determining the amount of the surplus to be distributed there shall be reserved an amount not less than the aggregate net value of all the outstanding policies.

Under this section and section 1950, the insurance commissioner of Wisconsin, as of December 31, in the years 1908, 1909 and 1910, certified his computation of reserves, and did not include reserves as against the contracts in question.

All the actuary would say about what was required by the insurance commissioner with reference to the reserve in question was, that the blank

that the company was compelled to fill in contained an item "reserve liabilities," but that no such item was included in "net reserve funds."

Section 1946x defines "'reserve' at any time within the policy year" and "terminal reserve." The latter is defined to be—

The sum sufficient, with the net premiums coming due, to provide for the future mortality charges, and mature the policy according to its terms, all computed upon the table of mortality adopted and the rate of interest assumed.

The end to be reached in life insurance is to mature the policy by building up a reserve. The basis of arriving at that desired end is the table of mortality and the rate of interest assumed, and by the use of them the net premium is fixed and the reserve is built up from net premiums. Repeating the process of making the terminal reserve from year to year until the time when the payment of premiums ceases, matures the policy. The net premium coming due is the foundation of the reserve. Actuary Evans states it thus:

The reserve is the balance of cash that the company must have on hand in order to pay out the contract, assuming that the future premiums under the policy are paid to the company, or, in other words, the increase in the reserve on the policy would be, specifically, the amount of the premium for that year paid in, interest on the entire sum, and the cost of the insurance deducted.

The assistant secretary (Anderson) explained that—

When the policy becomes a claim, it is charged off in the death loss account as a disbursement * * * for the full amount of the * * * policy.

When asked what, if anything, is deducted from the general reserve fund when death occurs, he answered:

A corresponding amount to the death loss which was taken out of disbursements—the reserve—is held on that policy. I mean that one part of reserve account is wiped out and another created.

Just here is the misconception as to what is a life insurance reserve. The reserve meant in the law is that fund which is built up to mature the policy. Of course, at the time when the money is taken out of the reserve account and is not used for immediate payment, it must be held somehow. In other words, it is reserved for the purpose of future payment. The full amount is there at the beginning, and there is nothing that has to be built up or matured. Nothing more can be reserved on that account.

We are of opinion that the decrease in the net value of assets because of amortization of premiums on bonds was not proper, and that the decrease in the net value of assets because of liability on supplementary contracts not involving life contingencies and canceled policies upon which a cash surrender value may be demanded was not proper, and that there should be deducted from the judgment of the court below on account of the first item the sum of $1,643.86, and on account of the latter item the sum of $9,969.08, an aggregate of $11,612.94, as of January 22, 1912, and that judgment should be entered for the sum of $131,755.84, being the principal of the original judgment less said sum of $11,612.94, with interest thereon at 6 per cent from January 22, 1912, with costs in the district court, which said interest amounts, to the date of the entry of the judgment in the district court on December 16, 1917, to $46,641.57. It is adjudged that each party pay its own costs of the proceedings in this court.

(T. D. 3058, August 16, 1920)

Income tax

Section 203, revenue act of 1918—Inventories of retail dry-goods dealers

Regulations No. 45 are hereby amended by inserting article 1588, reading as follows:

Art. 1588. *Inventories of retail dry-goods dealers.* (1) Retail dry-goods dealers who employ the "retail method," which is essentially a "cost" method of valuing inventories, will be permitted to make their returns upon that basis, provided (*a*) that the use of such method is designated upon the return (*b*) that accurate accounts are kept, and (*c*) that such method be adhered to in subsequent years, unless a change is authorized by the commissioner. The "retail method" consists in computing the "cost" of goods on hand from the "percentage of purchase mark-up" and the "retail value" of goods on hand.

(2) A taxpayer employing the "retail method" of valuing inventories shall maintain and preserve in permanent form, for the inspection of internal revenue officers, the accounts and records of each year, together with a schedule of all mark-downs in each department, and such mark-downs shall not be included in the computation of the retail value of goods on hand unless the goods so marked down have been actually sold.

(3) The following general plan of taking an inventory by the "retail method" will, it is believed, be found readily adaptable to the requirements of most retail dry-goods dealers:

(A) The *percentage of purchase mark-up* is computed as follows: The value of all merchandise, as received, is recorded by departments at two prices—(*a*) invoice cost plus transportation, and (*b*) original retail sale price. These cost and retail values are accumulated as recorded during the year. The total retail value minus the total cost value equals the total purchase mark-up, which divided by the total retail value gives the percentage of purchase mark-up.

(B) The *retail value of goods on hand* is computed as follows: A record is kept of (*a*) the amounts of all sales at retail; (*b*) any variations from the inventory prices of the preceding year of goods carried over from that year, and (*c*) any variations from the original sale prices, such as subsequent mark-ups or mark-downs (note par. 2). The retail value of the opening inventories plus the retail value of the purchases (plus or minus the algebraic sum of all subsequent mark-ups and mark-downs in the case of goods actually sold), minus the retail value of the sales equals the retail value of the book inventory of goods on hand. Physical inventories by departments are taken of goods on hand at retail at the close of the taxable year, and the retail value of the book inventory of goods on hand is adjusted accordingly.

(C) The *cost of goods on hand* is computed by subtracting from 100 per cent the percentage of purchase mark-up, which gives the percentage of cost, and multiplying the retail value of goods on hand by such percentage of cost.

(T. D. 3059, August 16, 1920)

Income tax

Stock dividends—Articles 1545, 1546 and 1642 of regulations No. 45 revoked, and article 1547 amended

In accordance with the recent decision of the supreme court of the United States in the case of *Eisner v. Macomber* (T. D. 3010), holding that a stock dividend is not taxable income to the stockholder, articles 1545, 1546 and 1642 of regulations No. 45 are hereby revoked, and article 1547 is amended to read as follows:

Art. 1547. *Sale of stock received as dividend.* Stock received as a dividend does not constitute taxable income to the stockholder, but any profit derived by the stockholder from the sale of such stock is taxable income to him. For the purpose of ascertaining the gain or loss derived from the sale of such stock, or from the sale of the stock with respect to which it is issued,

the cost (used to include also, where required, the fair market value, as of March 1, 1913), of both the old and new shares is to be determined in accordance with the following rules:

(1) Where the stock issued as a dividend is all of substantially the same character or preference as the stock upon which the stock dividend is paid, the cost of each share of both the old and new stock will be the quotient of the cost, or fair market value as of March 1, 1913, if acquired prior to that date, of the old shares of stock divided by the total number of the old and new shares.

(2) Where the stock issued as a dividend is in whole or in part of a character or preference materially different from the stock upon which the stock dividend is paid, the cost, or fair market value as of March 1, 1913, if acquired prior to that date, of the old shares of stock shall be divided between such old stock and the new stock, or classes of new stock, in proportion, as nearly as may be, to the respective values of each class of stock, old and new, at the time the new shares of stock are issued, and the cost of each share of stock will be the quotient of the cost of the class to which such share belongs divided by the number of shares in that class.

(3) Where the stock with respect to which a stock dividend is issued was purchased at different times and at different prices and the identity of the lots cannot be determined, any sale of the original stock will be charged to the earliest purchases of such stock (see art. 39), and any sale of dividend stock issued with respect to such stock will be presumed to have been made from the stock issued with respect to the earliest purchased stock, to the amount of the dividend chargeable to such stock.

(T. D. 3061, August 27, 1920)

Income tax

Deductions allowed—Depreciation—Article 166, regulations No. 45, amended

Article 166 of regulations No. 45 is hereby amended to read as follows:

ART. 166. *Modification of method of computing depreciation.*—If it develops that the useful life of the property has been underestimated, the plan of computing depreciation should be modified and the balance of the cost of the property, or its fair market value as of March 1, 1913, not already provided for through a depreciation reserve or deducted from book value, should be spread over the estimated remaining life of the property. Inasmuch as under the provisions of the income-tax acts in effect prior to revenue act of 1918 deductions for obsolescence of property were not allowed except as a loss for the year in which the property was sold or permanently abandoned, a taxpayer may for 1918 and subsequent years revise the estimate of the useful life of any property so as to allow for such future obsolescence as may be expected from experience to result from the normal progress of the art. No modification of the method should be made from the normal progress of the art. No modification of the method should be made on account of changes in the market value of the property from time to time. such as, on the one hand, loss in rental value of the buildings due to deterioration of the neighborhood, or, on the other, appreciation due to increase demand. The conditions affecting such market values should be taken into consideration only so far as they affect the estimated useful life of the property.

(T. D. 3062, September 1, 1920)

Income tax

Income to lessors of improvements made upon real estate by lessees—Articles 48, 109 and 164, regulations No. 45, amended

Articles 48, 109 and 164 of regulations No. 45 are hereby amended to read as follows:

ART. 48. *Rents and royalties.*—When buildings are erected or improvements are made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor receives income at the time when such buildings or improvements are completed, to the extent of the fair market price or value of such buildings or improvements subject to the lease. This amount would ordinarily be the difference between the value of the land free from the lease without such improvements and the value of the land subject to the lease with such improvements. If for any other reason than a bona fide purchase from the lessee by the lessor, the lease is terminated, so that the lessor comes into possession and control of the property prior to the time originally fixed for the termination of the lease, the lessor receives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he became entitled to such possession exceeds the fair market price or value thereof to him as determined when the same completed became part of the realty. No appreciation in value due to causes other than the premature termination of the lease shall be included. Conversely, if the buildings or improvements are destroyed prior to the termination of the lease the lessor is entitled to deduct as a loss of the year when such destruction takes place the fair market price or value of such buildings or improvements subject to the lease as determined when the same completed became a part of the realty, or the value thereof subject to the lease on March 1, 1913, less any salvage value subject to the lease, to the extent that such loss was not compensated by insurance. (See articles 109 and 164.)

ART. 109. *Rentals.*—Where a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent, and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment and not deductible as a business expense. In order to return to such taxpayer his investment of capital, an annual deduction may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining of the term of lease, and such deduction shall be in lieu of a deduction for depreciation. If the remainder of the term of lease is greater than the probable life of the buildings erected, or of the improvement made, this deduction shall take the form of an allowance for depreciation. (See article 48.)

ART. 164. *Capital sum recoverable through depreciation allowances.*—The capital sum to be replaced by depreciation allowances is the cost of the property in respect of which the allowance is made, except that in the case of property acquired by the taxpayer prior to March 1, 1913, the capital sum to be replaced is the fair market value of the property as of that date. In the absence of proof to the contrary, it will be assumed that such value as of March 1, 1913, is the cost of the property less depreciation up to that date. To this sum should be added from time to time the cost of improvements, additions and betterments, the cost of which is not deducted as an expense in the taxpayer's return, and from it should be deducted from time to time the amount of any definite loss or damage sustained by the property through casualty, as distinguished from the gradual exhaustion of its utility, which is the basis of the depreciation allowance. In the case of the acquisition after March 1, 1913, of a combination of depreciable and non-depreciable property for a lump price, as, for example, land and buildings, the capital sum to be replaced is limited to that part of the lump price which represents

the value of the depreciable property at the time of such acquisition. Where the lessee of real property erects buildings, or makes permanent improvements which become part of the realty and income or loss has been returned by the lessor as a result thereof, as provided in article 48, the capital sum to be replaced by depreciation allowances is held to be the same as though no such building had been erected or such improvements made.

(T. D. 3064, September 4, 1920)

Income tax

Deductions allowed—Depletion—Article 211, regulations No. 45, amended

Article 211, regulations No. 45, is hereby amended to read as follows:

ART. 211. *Computation of allowance for depletion of gas wells.*—On account of the peculiar conditions surrounding the production of natural gas it will be necessary to compute the depletion allowance for gas properties by methods suitable to the particular cases in question and acceptable to the commissioner. Usually the depletion of natural gas properties should be computed on the basis of decline in closed or rock pressure, taking into account the effects of water encroachment and any other modifying factors. The gas producer will be expected to compute the depletion as accurately as possible and submit with his return a description of the method by which the computation was made. The following formula, in which the units of gas are pounds per square inch of closed pressure, is recommended: The quotient of the capital account recoverable through depletion allowances to the end of the taxable year divided by the sum of the pressures at the beginning of the year, plus the sum of initial pressures of new wells and less the sum of the pressures at the time of expected abandonment (which quotient is the unit cost), multiplied by the sum of the pressures at the beginning of the taxable year, plus the sum of the initial pressures of new wells and less the sum of the pressures at the end of the tax year equals the depletion allowance.

Smith, Brodie & Lunsford announce the opening of offices at 2107-2109 Woolworth building, New York.

McLaren, Goode & Co., San Francisco, announce that Norman Loyall McLaren has been admitted to partnership.

Spragg, Lotz & Smith announce the opening of an office in the Central Savings Bank building, Canton, Ohio.

Edward R. Burt & Co. announce the opening of an office at 603 Union Trust building, Cincinnati, Ohio.

Walter M. Finlay announces the opening of an office in the Finlay building, Greenville, South Carolina.

Lingley, Baird & Dixon announce the opening of an office at Eldon Street House, Eldon street, London, E. C., England, under the direction of Baker, Sutton & Co.

Students' Department

EDITED BY H. A. FINNEY

AMERICAN INSTITUTE EXAMINATION, MAY, 1920

In regard to the following attempt to present the correct solutions to the questions asked in the examination held by the American Institute of Accountants in May, 1920, the reader is cautioned against accepting the solutions as official. They have not been seen by the examiners, still less endorsed by them.

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE

Part II (Continued)

Question No. 4:

Define the following and give a list of expenses which would properly come under each heading:

(a) Shop overhead.
(b) General overhead.

Discuss various methods of distributing such expenses.

Answer to Question No. 4:

The term "overhead" is subject to two definitions. One is that it covers only the manufacturing expense of a business; the other is that it covers the selling and administrative expense as well as the manufacturing expense. In cost accounting, the first definition would be used in accounting for the cost to manufacture; the second, in accounting for the cost to make and sell.

The factory overhead, consisting of manufacturing expenses only, may be divided into two classes: departmental overhead, which covers all manufacturing expenses which can be charged directly to the various departments, and general overhead, which includes all expenses that cannot be charged directly to departments but must be distributed over the factory as a whole. On this basis, examples of shop overhead are all indirect labor, rent, taxes, insurance, depreciation, maintenance and repairs, heat, light and power and defective work which can be charged to the several departments, while "general overhead" includes any of these or similar expenses which cannot be charged directly to departments.

If the second definition is used, all the foregoing are included as "shop overhead," while "general overhead" includes the selling expenses, such as advertising, salesmen's salaries and expenses and delivery expenses. It also includes the general and administrative expenses, such as office salaries, rent of office and miscellaneous expenses of administration.

On the basis of the first of the two above definitions, namely, that shop overhead is synonymous with departmental manufacturing expense and general overhead includes all other indirect manufacturing expenses, the

general overhead is apportioned among the departments on the basis of the direct-labor cost of each department or the number of direct-labor hours or machine hours in each department. Adding this distribution to the shop overhead would give the total departmental burden. This departmental overhead is then distributed among the jobs by either the direct-labor cost method, the direct-labor-hour method, the direct-labor-and-material-cost method or the machine-rate method. Under the direct-labor-cost method the overhead is distributed to the various jobs in the proportion the direct labor on the job bears to the total direct labor of the department. This is a simple method and is frequently employed, but it is not scientifically correct.

If the direct-labor-hour method is used, the overhead is distributed among the jobs in the proportion that the number of direct-labor hours spent on the job bears to the total direct-labor hours of the department. This method is more scientific than the labor-cost method, because the overhead represents the costs of the factory utilities, which are incurred in proportion to time rather than in proportion to wages paid.

By the direct-labor-and-material-cost method, the overhead is distributed in the proportion that the labor and material cost of the job bears to the total for the factory. It is applicable in only a few limited industries and is not advisable for a factory with several departments.

The machine-hour method is a highly involved method of apportioning the overhead to each machine and determining the cost of operating it for an hour. The overhead is then apportioned to the various jobs on the basis of the number of hours of machine operation. As accurate costs are essential, this is the most desirable of all methods.

Accepting the second definition of the two terms, the shop overhead is distributed to the cost of jobs by one of the methods already discussed. The general overhead, consisting of selling and administrative expense, must be distributed over the factory cost on some arbitrary basis to learn the cost to make and sell. The method usually followed is to distribute it on the basis of factory cost. However, where a varied line of products is manufactured, it is sometimes advisable to analyze the selling expense and charge each kind of goods sold with the selling expense applicable to it, as this may vary between the different kinds to such an extent as to give a wrong idea of the profitableness of each kind if a general average rate of distribution is used.

Question No. 5:

Explain and discuss four methods of providing for depreciation.

Answer to Question No. 5:

All depreciation methods are intended to result in writing off during the estimated life of a fixed asset the difference between its cost and the residual value which it is estimated can be realized from the asset when it is no longer advantageous to use it as a productive agent. The methods discussed will be illustrated by applying them to the case of a machine

costing $6,000.00, with an estimated life of four years and an estimated residual value of $1,000.00.

(A) Straight line method. By this method the difference between the cost and the residual value is divided by the number of periods of estimated life to determine the periodical depreciation. The formula for this method is:

$$d = \frac{c - s}{n}$$

In this formula

d = amount of periodical depreciation,
c = cost of asset,
s = estimated residual or scrap value,
n = number of periods of estimated life.

Then

$$d = \frac{6{,}000 - 1{,}000}{4}$$
$$= 1{,}250.00.$$

The following table shows the annual depreciation charges and the carrying value of the asset:

Depreciation Table—Straight Line Method

Year	*Depreciation*	*Carrying value*
		$6,000.00
1	$1,250.00	4,750.00
2	1,250.00	3,500.00
3	1,250.00	2,250.00
4	1,250.00	1,000.00
Total	$5,000.00	

(B) Diminishing value method. The expense of using a fixed asset consists of two elements: depreciation and repairs. Some accountants maintain that the sum of these two elements should be fairly uniform year by year; and since repairs tend to increase, the depreciation should be charged off in a decreasing scale so that a large charge will be made for depreciation in the early years when repair charges are light, and a small charge will be made for depreciation in the later years when more extensive repairs are necessary. Diminishing annual charges are also defended on the ground that an asset loses more value during the first year than during any other because use makes it second-hand. This reason is subject to the rejoinder that since depreciation is an operating expense it should be based on values of a going concern and not on realizable values.

Diminishing charges are obtained by applying the same rate periodically to the diminishing carrying value. This rate is likely to be underestimated unless computed by the formula

$$r = 1 - \sqrt[n]{\frac{s}{c}}$$

Applied to the illustration

$$r = 1 - \sqrt[4]{\frac{1{,}000}{6{,}000}}$$

Logarithms are required to extract the fourth root of the fraction 1/6 the procedure being as follows:

Log. 1 =	.000000 or 10.000000 — 10
" 6. =	.778151
" 1/6 =	9.221849 — 10
Or adding	30. — 30
Log. 1/6 =	39.221849 — 40

39.221849 — 40 ÷ 4 = 9.805462 — 10 the log. of $\sqrt[4]{1/6}$ 9.805462 — 10 is the log. of .63894265.

Then r = 1 — .63894265
= .36105735
= 36.105735%

Depreciation Table—Diminishing Value Method

Year	*Depreciation 36.1057% of carrying value*	*Carrying value*
		$6,000.00
1	$2,166.34	3,833.66
2	1,384.17	2,449.49
3	884.41	1,565.08
4	565.08	1,000.00
Total	$5,000.00	

(C) Sum-of-years'-digits method. The method just described is difficult to apply unless the use of logarithms is understood. A diminishing periodical charge can be obtained more easily by the sum-of-years'-digit method. In the case of an asset with a life of four years, the years' digits are 1, 2, 3, 4, and the sum of these digits is 10. The periodical depreciation charges are computed by multiplying the total depreciation by a series of fractions, the denominator of each of which is the sum of the digits and the numerators of which are the digits themselves, taken in inverse order.

Depreciation Table—Sum-of-Years'-Digits Method

Year	*Fraction*	*Depreciation*	*Carrying value*
			$6,000.00
1	4/10	$2,000.00	4,000.00
2	3/10	1,500.00	2,500.00
3	2/10	1,000.00	1,500.00
4	1/10	500.00	1,000.00
Total		$5,000.00	

(D) Annuity method. This method is based on the assumption that the cost of manufacture should include interest on the investment in fixed assets as well as depreciation. The two elements are charged in one amount to depreciation, with two offsetting credits: a credit to interest, diminishing periodically as the carrying value of the asset decreases, and a periodically increasing credit to the reserve for depreciation or to the asset account. In other words, the investment in the fixed asset is treated as if it were the present value of an annuity.

The formula for computing the periodical depreciation is

$$d = \frac{c - (s \times p)}{D \div i}$$

The symbols in this formula, not used in preceding formulas, are:

p = present value of \$1,
D = compound discount on \$1,
i = simple interest rate.

If manufacturing cost is to be charged with 5% interest on the diminishing investment, i is 5%, and p is computed thus:

1.000000 ÷ 1.05 = .952381 P. V. of 1 due 1 period hence,
.952381 ÷ 1.05 = .907029 P. V. of 1 due 2 periods hence,
.907029 ÷ 1.05 = .863838 P. V. of 1 due 3 periods hence,
.863838 ÷ 1.05 = .822702 P. V. of 1 due 4 periods hence.

Then D, the compound discount, is 1 — .822702, or .177298, and

$$d = \frac{6{,}000 - (1{,}000 \times .822702)}{.177298 \div .05}$$

$$= \frac{6{,}000 - 822.702}{3.54596}$$

$$= 1{,}460.06.$$

Depreciation Table

Year	*Charge depreciation*	*Credit interest* (5% of carrying value)	*Credit reserve*	*Carrying value*
				$6,000.00
1..........	$1,460.06	$300.00	$1,160.06	4,839.94
2..........	1,460.06	242.00	1,218.06	3,621.88
3..........	1,460.06	181.09	1,278.97	2,342.91
4..........	1,460.06	117.15	1,342.91	1,000.00
	$5,840.24	$840.24	$5,000.00	

Question No. 6:

How would you deal with the following items in preparing the annual accounts of a company?

Comment briefly on any points which would need special consideration:

(a) Goodwill.
(b) Repairs reserve account.
(c) Unclaimed dividends account.
(d) Bond issue expense account.
(e) Preliminary expense account.
(f) Expenditure during the year on leasehold property.

Answer to Question No. 6:

(a) Goodwill should appear in the balance-sheet as an asset, the most fixed of all assets, because it cannot be sold without selling the business. Its valuation should not be greater than the price actually paid for it, because it is improper to write up the account no matter how profitable the business may be. On the other hand it is not necessary to write off the account. Goodwill does not depreciate; and, although it fluctuates in value as profits increase or decrease, fluctuations should not be reflected in the account. The goodwill account has been so abused in the past by having been made to carry the water in the stock, that the account has been discredited. For this reason, and for purposes of conservatism, many concerns have written it off. When this is done the charge should be made to surplus and not to profit and loss.

(b) Realizing that repair charges are usually smaller during the earlier years of the life of an asset than during the later years, and desiring to equalize the charge over all the years of estimated life, some concerns charge operations with the estimated average annual expense for repairs and credit a reserve. Actual repair expenditures are then charged against the reserve. In preparing the annual accounts of a company which has adopted this policy, the estimated life and total probable repairs should be verified as well as possible; the charges to the reserve should be examined to see that they do not represent capital expenditures; and the charges to the fixed asset accounts should be verified to see that they do not represent repair charges which should have been charged to the reserve. The balance of the reserve should be shown on the liability side of the balance-sheet and not as a deduction from the assets.

(c) Unclaimed dividends should be shown as a current liability. If cheques have been issued, the liability account set up when the dividend was declared will have been closed and the cash account reduced. When cheques have been outstanding for a long time, or when stockholders cannot be found, it is desirable after verifying the fact of non-payment to show the liability on the balance-sheet.

(d) If the bond issue expense is small and the bonds are issued at par, it is best to get rid of the account at once by writing it off to surplus. If the bonds were issued at a discount the expense could be amortized with the discount by charges to bond interest. If the bonds were issued at a premium the expense could be offset against the premium, thus reducing the periodical amortization. Any balance remaining in the expense account would be shown on the balance-sheet as a deferred charge, though it would seem preferable

to get rid of the account by closing it to surplus, if small, or to bond discount or premium. It would be desirable to carry the account along only in case the amount was large and the bonds were issued at par.

(e) It is customary to write off the preliminary expense during the first years of the company's life, say three or five. The charge should be made to surplus and not to profit and loss, because it is not a current operating expense. The balance not written off should be shown as a suspense debit on the balance-sheet.

(f) If the expenditures on leasehold property are ordinary repairs, they should be charged off at the end of the year and be included with the rent in the profit and loss statement. If they represent alterations or improvements they should be charged to leasehold improvements and written off during the life of the lease. The charge for the amount written off should be made to rent, and the balance of the leasehold improvements account should appear on the balance-sheet as a deferred charge.

Question No. 7:

It being understood that in well-managed industrial concerns large expenditures for construction should not be made unless they are properly authorized, discuss in detail a method for preparing requisitions for such work, describing the information that should be shown and the form which authorization should take.

Answer to Question No. 7:

It is assumed that in a well-managed industrial concern, the functional plan of organization would be in vogue. This would include a planning and engineering department which would prepare plans and make estimates of the cost of any new construction which might be considered. New construction would probably be authorized by the board of directors, and before authorizing it they would require the planning department to furnish an estimate of the probable cost. An order would be issued to the planning and engineering department to prepare plans and determine approximate cost of the proposed construction, and the cost of their work would be charged to this order.

If the directors decide to proceed with the work, they might enter into a contract with a construction company, in which case the question of requisitions would not be involved. If the work is to be done by the concern itself, requisitions for material would be issued through the regular channels of the purchasing department, and the utilization of material and labor would be authorized by the general manager through the customary form of production orders. The production order for construction would be supported by material requisitions and labor reports, and the cost of construction should include the correct proportion of manufacturing expense.

Question No. 8:

(a) What is the effect of depreciation upon the operating results of a business?

(b) Is a charge for this purpose recognized under the income-tax regulations?

(c) If the authorities disallow any charge which has been made upon

the books, state specifically how the amount disallowed should be treated in subsequent income-tax returns.

Answer to Question No. 8:

(a) Depreciation is an expense to be accounted for before the true operating results of a business can be known.

(b) The income-tax regulations provide that "a reasonable allowance for the exhaustion, wear and tear and obsolescence of property used in the trade or business may be deducted from gross income."

(c) If depreciation is disallowed it should be treated as an increase in the invested capital in subsequent income-tax returns.

Question No. 9:

A merchant going abroad to purchase goods secures from his bank, on the strength of his general financial standing, a letter of credit for use in his contemplated purchases of $500,000.

How should the issuance of this letter of credit be shown in the accounts of the bank?

Answer to Question No. 9:

The bank would record the issuance of the letter of credit by a $500,000 debit to "customers' liability on letters of credit," offset by an equal credit to "liability on letters of credit."

Lawyer vs. Accountant in Partnership Liquidation—(*Concluded*)

Editor, Students' Department:

Sir: In an article appearing in the *Students' Department* of the May issue of The Journal of Accountancy, entitled *Lawyer vs. accountant in partnership liquidation,* an argument submitted by me to the editors of the *Students' Department* is quoted and commented upon, and I desire to express my appreciation and thanks to the editors for their consideration and criticisms of the matter and the argument I submitted.

The problem submitted need not be here re-stated, nor the questions of the candidate relating to the problem, although as to the latter I may say that in my letter directed to the editors, as against the contention that there was a gain, I advanced the contention that there was a loss, so to submit two extremes, although my personal opinion was, and is, that the partners should share the $90,000.00 worth of stock on an equal basis.

Further, it may be interesting to state that this problem, together with the same letter (except as to address), was submitted to several accounting authorities, and as to the question submitted, replies were received as follows:

One authority stated that both contentions were wrong.

One authority stated that both contentions were right.

The editors stated there were three possible alternatives.

One university stated that there was a gain because "fiction must prevail over fact."

And I am mindful at this point that Mr. Richardson, the editor of The Journal of Accountancy in the May, 1919, issue, at page 365, states that "the accountant is concerned with facts and the lawyer with theories"; but the above illustrates that many theories must have been concerned to produce so many different expressions of fact relative to the same accounting question.

By way of reply to the published article of the editors, and to obtain a view of what has been and is to be considered, I will separate the matters considered in the editors' article into two divisions.

First: 1. C. P. A. examination problem submitted,
2. Question of candidate relating to problem,
3. Answer of editors offering three alternatives,
4. Reply of candidate requesting editors' election as to which of the three alternatives might be deemed most reasonable with no facts to consider other than those related in the problem,
5. Answer of editors to candidate's reply;

the above embracing about the first half of the editors' article; and,

Second: The argument in favor of equal division of goodwill, where facts are identical with those submitted in the C. P. A. examination problem, except that the $90,000 for goodwill is actually paid in cash;

embracing approximately the remaining half of the editors' article.

FIRST

Question: With nothing more than is given in the problem, is it just to divide the stock on any other basis than an equal one?

The editors state: "We most emphatically say that, in our opinion, it would be absolutely unjust to divide the stock equally except under hypothesis (a) of our letter of December 1st." The letter of December 1st offers three hypotheses, as follows:

(a) The stock may be taken as worth what is paid for it.

(b) The stock may be taken over at par.

(c) The stock may be taken as worth only fifty cents on the dollar, although there does not appear to be anything at the time of the transfer to indicate such a value.

And nothing is stated by the editors as to whether it is more reasonable to consider (a) in preference to either one of the other two. It is only possible to acquire an insight as to whether or not the editors regard (a) as the hypothesis to be preferred from their statements relating to (b) and (c).

The editors state that "(c) need not be considered." However (c), expresses, for all practical purposes, an alternative exactly opposite to (b), and if as in (c) there may be a loss, or as in (b) there may be a gain, then if the facts offered are sufficient to warrant the dismissal of (c) the same facts must be sufficient to warrant the dismissal of (b), and therefore only (a) remains.

By way of further explanation, it may be said that (c) is based upon the sale of stock at some time after the partnership transaction, but (b) is not even based upon any fact recited in the problem either before, after or at the time of the transaction, and if it is regarded that (c) need not be considered, because it is based upon a fact given, but that fact relates to a time subsequent to the partnership transaction, how much more conclusive is it that (b) need not be considered because it is based upon the fact as to which not even a hint is given in the recital of facts contained in the problem?

If (b) and (c) "need not be considered," then only (a) remains, and I take it the editors, by the answer "we most emphatically say that in our opinion it would be absolutely unjust to divide the stock equally except under hypothesis (a)," are in fact stating that with nothing more than is given in the problem, it is unjust to divide the stock in any manner other than on an equal basis.

This is inadvertently corroborated by the statement of the editors: "It is probable that the (b) statement was the one contemplated, as it gives at least a nominal value to goodwill." Why use the term goodwill? Almost any other word might do just as well. No facts are related in the problem

which indicate that the business has any goodwill, unless in general it can be conclusively considered that any business in need of "more capital," and finding itself confronted with the necessity of "providing working capital," because of these circumstances alone has a valuable goodwill.

Bearing in mind the comment of the editors contained in the first three lines on page 310, of the October, 1919, issue of THE JOURNAL OF ACCOUNTANCY, why not use the term "manna" instead of goodwill, on the ground that this asset must have dropped from heaven, since there appears to be no earthly way of accounting for it. Further, if (b) gives only a nominal value which requires $90,000 to express it, then how much greater an amount, in the view of the editors, would be necessary to express a simple and ordinary value?

SECOND

Question: In any circumstances, should the acquisition of goodwill be regarded as producing an ordinary profit?

The argument advanced and quoted in the editors' article is that the acquisition of goodwill occurs in the course of time and is associated with the profits earned by the operations of the business in the course of time. Goodwill could not be established by itself, in the absence of other assets, or without contemplating something else with it; and goodwill becomes established with and pertaining to something else, with which it becomes merged, and it is inseparable therefrom.

Goodwill is an advantage or benefit which is acquired by an establishment, beyond the mere value of the capital stock, funds or profit employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position or common celebrity or reputation for skill or affluence or punctuality, or from other accidental circumstances or necessities, or even from ancient partiality or prejudices.

The goodwill of a business practically consists of that favorable reputation it has established creating a disposition or inclination of persons to extend their patronage to the business on that account, and, as the business is always associated with the name under which it is conducted, the name becomes a part, and often an important part, of its goodwill.

Goodwill of a partnership is a part of the property of the firm. It is every advantage that has been acquired by the old firm in carrying on its business whether connected with the premises in which the business was previously carried on or with the name of the last firm.

As goodwill is abstract, cannot be seen and handled, it must be speculative. It is liberally paid for in many cases because the purchaser speculates in the matter of hoping to collect future profits, basing his estimate of the value of goodwill on what he expects to collect in the future.

Thus the purchaser pays because he hopes for future profits, and the seller is not paid because of the future profits, but because of past profits (which he has already received), the buyer being willing to pay for goodwill by basing his hope for future profits on the established facts relating to past profits.

I appreciate what is regarded as good accounting, and I agree with all that the editors say, because my argument is not given in support of any accounting method, but merely offered to illustrate one point, viz.:

That goodwill is established in the course of time, and is associated with other assets from which it cannot be separated, and that it is an abstract quality of an absolutely speculative nature; and an accounting method cannot prejudice the expression of a true fact, nor should an accounting method attempt to do so for no other purpose than to give "nominal value to goodwill."

The editors' reply, offering an illustration, stating if the inventory is worth \$10,000 more on the market that then such \$10,000 is additional profit, etc., calls for the comment that there is just as much recited in the problem concerning this as concerns the possibility that any real goodwill is present. The editors further state that the partners "arrange to sell it to the corporation for what are presumably good shares of stock"; but here again the facts stated in the problem (and the editors' reply as well) fail to offer any suggestion as to who the presumptive parties are, the partners or the editors, and exactly how far the presumption is to extend.

The editors state that I express anxiety to prevent Brown and Smith from deriving any profit from the goodwill, but I am only concerned about Smith's not getting a square deal, as it is my firm opinion that the partners should divide, even cash received, on an equal basis.

I do not say this with a view of casting any reflection upon the view of the editors, as I regard all their articles as commendable and of great value to the accounting profession. However, too often accountants are bound by the conventions of their profession. Rules and methods are commendable, but accountants should, and I think they do, recognize that there may be an exception to almost any rule or method.

My opinion is that where goodwill is realized it should not be regarded as an ordinary profit. The term profit is ordinarily used in the sense that it refers to profits derived from ordinary business operations of a business; and where partners agree to engage in business as partners and to divide all profits on a certain basis such agreement relates to ordinary and not speculative profits.

When partners are selling out they are no longer conducting the business, even though selling the business as a going concern. As a matter of law. and I may say common-sense, the difference between that which is ordinary and that which is speculative presents nothing that is new either in theory or in fact.

Almost everyone appreciates that by the word "profit," when applied to the operating of any business, is meant the profit derived from the operations conducted within the scope of the operations of the particular business in question. Partners agreeing to divide the profits of their business on an unequal basis mean their usual operating profits, and goodwill is not a usual operating profit. It is speculative, in that it is derived from that which someone expects to acquire in the future.

Suppose Brown and Smith desire to establish a partnership to engage in a certain line of business, and each turns over to the partnership \$205,000 market value of certain stock. For the purpose of this illustration identify such stock as "Stutz." It is arranged that B is to acquire certain assets necessary to carry on the proposed business, and Smith is entrusted with the stock for the purpose of at once disposing of it, to obtain cash to pay for the assets acquired by B.

If Smith negligently fails to dispose of the stock until a week later, and in the meantime the market value of stock has doubled, Brown and Smith have made \$410,000 before the partnership really began, and not because of anything that either of them did, but rather because one neglected to do something as promptly as it should have been done. Would anyone suppose that Brown and Smith contemplated such profit when they agreed to divide the profits of the business, which they intended to establish, on an unequal basis?

By way of another illustration, it may be stated that a few years ago the old Hotel Gibson, at Cincinnati, was destroyed by fire. This occurred after the corporation owning it had already contracted to pay for the demolishing of the building to make way for a new and modern structure. In consequence of the fire the company not only found itself with the building out of the

way, but saved a considerable sum which it had already contracted to pay to have it demolished, to say nothing of the gain in the matter of time that would have been required to raze the building, and in addition to all this a large sum of insurance carried on the old building was paid to the company.

Had Brown and Smith been involved in that matter, would the insurance collected have been regarded the same as profit derived from the ordinary operations of the business conducted by them?

In conclusion, I will say that my opinion is it is unreasonable for a partner interested in one-half of certain assets with another partner, but sharing the greater part of the profits, to claim the greater share of that which is received for goodwill for the following reasons, viz.:

That which is received is paid by a purchaser because certain extraordinary profits have been earned in the past, but when such profits were earned they were then divided on an unequal basis. To say that because one partner has already received a greater part of the profits, he should also receive the greater part of an amount paid by a purchaser in excess of the real value of other assets acquired is altogether unreasonable, because that abstract quality for which the purchaser pays cannot exist by itself, but does exist only in conjunction with something else from which it is inseparable.

The argument of the editors rather suggests the action "of a man trying to overtake his shadow while walking east on a sunny afternoon." To create a nominal asset and give it "nominal value" ($90,000), although "the existence of any goodwill is more than doubtful," is to be commended and applauded as fully as the accomplishment of the man who walks eastward every sunny afternoon in an attempt to overtake his shadow.

Respectfully yours,

May 15, 1920. L. F. Ratterman.

[It was Mr. Walton's desire that this communication from Mr. Ratterman be published, but his death occurred before the copy for this issue was completed. The following reply is written with the hope that it will express Mr. Walton's opinions.—H. A. F.]

The details of the problem published in The Journal of Accountancy of May, 1920, have no doubt been forgotten. The essential facts are these: Brown and Smith were partners with equal capital accounts, sharing profits and losses by agreement in the ratio of 60% and 40%, respectively. The business was incorporated, and the partnership transferred net assets of $410,000 for $800,000 par of stock, later donating $300,000 of stock to the corporation. Therefore the partnership liquidated with $500,000 of stock which it received for $410,000 net assets and $90,000 goodwill. Mr. Ratterman contends that the $90,000 of stock received for goodwill should be divided equally because it was obtained as an extraordinary profit; it is our contention that the profit of $90,000 on the sale of the goodwill should be divided in the agreed profit and loss ratio of 60% and 40%, because a contract is a contract, and the agreement of the partners governs the division of all profits, ordinary and extraordinary.

In support of his contention, Mr. Ratterman states that "partners agreeing to divide the profits of their business on an unequal basis mean their usual operating profits, and goodwill is not a usual operating profit." If that is what they mean they should state the fact clearly. If Brown and Smith had intended that the operating profits estimated yearly should be divided

60% to Brown and 40% to Smith, and that any profits realized by the sale of the business should be divided equally, they should have, and probably would have, made such an agreement. Instead, they agreed to a 60% and 40% ratio for the division of profits without qualifications.

When partners thus clearly state their desire to share profits in a certain ratio, it would seem that an accountant ought to feel bound to divide the profits in accordance with the agreement. It is this respect for a contract which Mr. Ratterman refers to when he states that "too often accountants are bound by the conventions of their profession." Although Mr. Ratterman is an attorney, he does not seem to feel the same obligation to abide by the terms of a contract. Some unrevealed evidence has convinced him that while the partners say 60% and 40% they mean 60% and 40% part of the time and 50% and 50% the rest of the time. He is "concerned about Smith's not getting a square deal"; he wants Smith to have 50%, although Smith agreed to take 40%. Presumably the partners themselves are the best judges of what constitutes a square deal. Judged by this standard, how square a deal would Brown get if Mr. Ratterman succeeded in giving him 50% instead of 60%?

In one paragraph Mr. Ratterman makes a distinction between ordinary profit and extraordinary profit, and quite properly classifies the profit on the sale of goodwill as an extraordinary profit. He concludes the paragraph thus: "Where partners agree to engage in business as partners, and to divide all profits on a certain basis, such agreement relates to ordinary and not speculative profit." In other words, all does not mean all; it means a portion.

(*To be concluded in November*)

George Shedden

George Shedden, member of the American Institute of Accountants, certified public accountant of Washington, died suddenly at Walla Walla, Washington, August 19, 1920. Mr. Shedden was a member of the firm of Shedden & McAdam. He was born in Glasgow, Scotland, in 1856, and came to America when seven years of age. He was educated in Boston, Massachusetts, and later returned to Scotland, where he was graduated from the university of Edinburgh. He had resided for twenty years in Tacoma, and was prominent in the accounting profession. For fourteen years he had served as a member of the state board of accountancy, and was secretary and treasurer at the time of his death.

The Journal of Accountancy
Official Organ of the American Institute of Accountants

Vol. 30 NOVEMBER, 1920 No. 5

Neglected Commercial Discounts

J. Hugh Jackson

The old adage that accounts which fail to tell the truth are worse than no accounts at all is open to the wide interpretation as to what constitutes truth. The common method of handling commercial discounts has been to debit a merchandise discount account for all discounts taken by customers on sales which the business has made to them and to credit the merchandise discount account for all discounts which the business takes on purchases made from others. The counterbalancing entry, obviously, is a credit to the customer or a debit to the creditor for the amount of the discount. In many cases the more progressive bookkeeper has divided the merchandise discount account into a discount on sales account and a discount on purchases account; but the principle stated above still remains true. It is only the amount of the discount allowed or received that is recorded on the books of the business.

When it comes to the income statement there is considerable variation in the methods used by accountants. Discounts on sales are considered (a) as a deduction from gross sales in order to ascertain net sales, (b) as a selling expense and are included in the operating section of the income statement or (c) as a collection expense and are grouped among the administrative expenses of the business. Good arguments may be advanced perhaps for any of the methods mentioned. Discounts on purchases are either deducted from gross purchases, to ascertain the net purchases of the period, or are treated as a sort of interest income in the other-income section of the income statement. The writer believes that in each case the element of discount should be added to the real sales or purchases to determine the net sales revenue or purchases

outgo of the period; and the reason will be obvious as this discussion proceeds.

The purpose of accounting is to reveal the true condition of a business. But does the balance-sheet of a business, when presented to the proprietors or stockholders thereof, show all facts which are vital to the successful continuation of that business? Even when combined with the income statement, as ordinarily constructed, much of this information is lacking. The value of the assets and the amount of the liabilities, the net proprietorship, the earnings of the year, the gross sales and other interesting facts may be shown. But what is the credit condition of the business? Does it pay its bills promptly? Are its accounts receivable slow pay? Many such vital questions may arise in the mind of the stockholder, and it is the purpose of this paper to suggest one method by which some information of this nature may be obtained.

In the purchase and sale of merchandise a discount for quick payment is usually allowed. A few of our great corporations have standardized this rate at one-half of one per cent per month, but this can scarcely be considered a commercial discount as that term has been used and as it is usually understood. The ordinary discount makes quite a distinction between a quick and a slow payment. Thus, on a certain purchase a discount of 5 per cent may be allowed for payment within ten days, 3 per cent for payment within thirty days, or prices are net if paid within sixty days. The real value of the merchandise is the gross selling price less the maximum discount allowable. To state this another way, the man who pays his bill within the ten-day period is paying the value of the merchandise itself much more nearly than is the man who pays his bill at the expiration, let us say, of the sixty-day period. A business with good credit and with good management will see to it that the highest discount offered is taken, and if this discount is deducted from the gross purchases of the period the books will show a correspondingly low valuation for the merchandise. On the other hand, the business with such poor credit that it can pay its bills only at the last minute will be paying the maximum price for its merchandise, and it is very likely to happen that the business with the poorest credit will have the highest value for its merchandise on its books. This discount should not be considered as adding anything to the value of the merchandise, for the cost of manufacturing or distributing the goods sold to the sixty-day man can

be no greater than that of the goods sold to the man who paid his bill promptly. The 5 per cent has nothing to do with the merchandise; it is entirely a payment for delay and for the risk involved. This infers that the merchandise should be charged to the merchandise or purchases account at the gross figure less the maximum discount allowed; and that is exactly what should be done. The gross cost should not be entered to the merchandise account even temporarily, but the discount allowed should be provided for in some other way.

This requires, in the treatment of purchase and sales discounts, a complete shift in the point of view from that usually maintained. Discounts taken on accounts payable are not profits, but neglected discounts are losses. Anyone could have purchased the goods at the minimum price. It is only because the business is unable to take advantage of these discounts that money is lost, and this is the fact that should be known to the proprietors or stockholders of that business. Likewise, discounts allowed on sales are not losses, but collected discounts are profits. The business is perfectly willing to sell any and all of its product for the gross price, less the maximum discount, and anything over and above that which is collected because of delayed payment on the part of the customers is pure profit. The sales account should be credited for only the amount which the business is willing to accept for a cash payment within the minimum discount period, for that is the real sale value of the merchandise. The balance is a payment by the customer for the risk assumed by the business on his account, and the books should show that fact.

In the case of public utilities, this question of discounts not taken or of forfeited discounts has been given considerable attention. No attempt is made here to exhaust the subject, and a few of the state regulations are referred to only as showing the trend in this direction. In the uniform classification of accounts for electric companies prescribed by the public service commission of Pennsylvania, effective January 1, 1919, account No. 333, under operating revenue accounts, is entitled "consumers' discounts forfeited and penalties imposed." It is prescribed for classes A, B, and C electric utilities, and provides:

> "Credit to this account the amounts of those discounts the utility allows its consumers on condition that they pay their electric bills on or before a specified date, and which are

> forfeited by the consumers because of their failure to pay their bills within the specified time.
>
> "Credit also to this account the amounts of penalties imposed by the utility on its consumers because of their failure to pay their electric bills within a stated time."

A similar provision is made for class D electric utilities through account No. 36 shown in the appendix to the regulations. The accounts do not definitely state how this income shall be reflected in the income statement, but it would undoubtedly be shown as a separate item, showing definitely the amount of revenue realized from this source. This would mean that the several accounts recording metered sales of electricity would be credited for the amount charged customers less the amount credited to the account No. 333 referred to above, thus showing in the several "metered sales" accounts the real value of the commodity sold.

The public service commission of Missouri, through its general order No. 12, effective January 1, 1915, and prescribing a uniform system of accounts for electrical corporations, provides revenue account No. 181, "discounts forfeited," to which shall be credited "all revenues derived from the forfeiture of discounts by consumers."

Other commissions, such as those of New Jersey and Maryland, maintain the old view and provide in substance that "credits to the various revenue accounts shall be made upon the basis of bills rendered or of gross prices," and that "discounts for prompt payment, corrections of overcharges, overcollections theretofore credited and afterward corrected," etc., shall be "charged to the revenue account to which they relate."

Still other state commissions, notably that of Colorado, in its uniform system of accounts for gas utilities, effective January 1, 1916, provide that "where it is the custom of the utility to grant a discount from the gross bill or to add a penalty to the bill where payment is not made on or before a prescribed date, such discounts or penalties shall be charged or credited" to the earnings from sales for (a) commercial lighting or (b) commercial fuel. However, "utilities desiring to do so may open sub-accounts to show the minimum bill and the discount or penalty items."

In this respect, then, while some state commissions have taken no definite action on the question, the trend is somewhat in advance of commercial accounting. Yet the commercial business, due to keen competition on all sides, has a far greater need of knowing

definitely every source of income and every possible point of leakage. It is for this very reason that the commercial executive should have placed before him clearly the facts concerning neglected discounts on purchases and collected discounts on sales, as well as the discounts actually taken both on purchases and on sales.

The next question to consider, then, is the ease with which this information may be obtained. The principle is simple, and the two-column sales book and purchase book only will be used for the sake of illustration. Suppose a purchase is made of Hawthorne & Co., under date of Dec. 5th, amounting to $1,200.00, terms, 5/10, 3/10, n/60.

Purchase book

Date	Folio	Acc'ts and explanation	Purchases	Purchase discounts allowable
Dec. 5.....	×	Hawthorne & Co......	$1,140.00	$60.00

The entry above is self-explanatory. Accounts payable (and Hawthorne & Co.) are credited for $1,200.00, merchandise purchases account is debited for $1,140 (the real value of the merchandise), and purchase discounts allowable is debited for the allowable discount, $60. At the end of the month the posting would be similar to that given for the one transaction above, and the individual creditors would be credited as from any other purchase book. In the cashbook there would be on the credit side of the book the ordinary column for accounts payable and the column for discounts taken on purchases. If a bill was paid within the credit period the discount would be taken, and the entry would be made exactly as has always been done for a similar transaction.

The sales book would be similar to that above shown, the two right-hand columns being entitled "sales" and "sales discounts allowable." The customers' remittances would be entered in the cashbook, as has always been done, and the discounts shown in the discounts taken on sales column when they were taken. There is no complication whatever in the method of handling either the purchase book or the sales book, and there would be no change from the usual method of handling the cashbook either for receipts from customers or for disbursements on account of accounts payable. The principle may be applied equally well to the multiple-column book, and to any of the various methods of handling purchase and sales invoices.

In the ledger either one or two accounts may be kept for the purchases and a like number for the sales. The writer prefers the four accounts, for there would be no question then concerning the meaning of the amount in any one of the accounts. The accounts might be entitled "purchase discounts allowable," "discounts taken on purchases," "sales discounts allowable" and "discounts taken on sales."

Suppose, to use the illustration above given, that the business paid the bill of Hawthorne & Co. thirty days after the purchase and received a 3 per cent discount thereby. If this was the only transaction for the period under consideration, the ledger accounts would stand as follows:

Merchandise purchases			
12/5	$1,140.00		

Purchase discounts allowable			
12/5	$60.00		

Hawthorne & Co.			
1/4	$1,200.00	12/5	$1,200.00

Discounts taken on purchases			
		1/4	$36.00

Cash			
		1/4	$1,164.00

The purchase discounts allowable account shows that the business was entitled to take a $60 discount, but the business failed to take that discount. As a result, instead of showing a $36 profit because of discounts taken on purchases, which is the common method of looking at the transaction, this shows that the business has lost $24 which it might have saved. Here is a leak that the business should know about, but under ordinary methods of accounting would not only not be known, but the management would tend to pat itself on the back because of the $36 profit it had made by taking the discount. The transactions of a month or of a longer period would show the same results and the ledger accounts would give information much more of value to the management than under the more common method of handling the accounts. Similar transactions might be used to illustrate the sales discounts allowable and the discounts taken on sales accounts, but the result is too obvious to require further illustration or explanation.

At the end of the monthly or fiscal periods the discounts taken on purchases account may be closed into the purchase discounts allowable. Any balance will be on the debit side of the account, and will show by how much the business failed to take advantage

of the discounts that it might have taken. If advantage of every discount was taken, the accounts would obviously balance each other. This proves our thesis as above stated that the discounts taken on accounts payable are not profits, but that the neglected discounts are losses. For purposes of closing the ledger accounts and of preparing the manufacturing or operating statement the losses from neglected purchase discounts or the profits from collected sales discounts may be handled in the manner that the individual business or accountant desires. The writer prefers to attach them directly to the purchases and sales, so as to show the gross cost or return from these merchandising operations. If preferred, the loss from neglected discounts on purchases may be shown as an operating loss, or both the loss on the purchase discounts and the profit on the collected sales discounts may be included in the other income and expenditures section of the income statement. It is important to observe, however, that under the method here outlined the balance of merchandise on hand will be valued at the minimum price, regardless of whether advantage of the purchase discounts allowable was taken or not. To make the point perfectly clear, let us assume that the purchase of merchandise from Hawthorne & Co. consisted of 1,000 units of goods. Assume further that 900 of these units were sold at $1.50 per unit, that a 5 per cent discount was allowed on the sales, but that sales discounts of only $50 were actually taken by customers. The income statement might then appear as follows:

Income statement for month ended December 31st

Sales, 900 units at $1.50, less 5%			$1,282.50
Sales discounts allowable	$67.50		
Less: discounts taken on sales	50.00		
Profit from collected discounts			17.50
Gross income from selling			$1,300.00
Contra:			
Purchases, 1,000 units		$1,140.00	
Purchase discounts allowable	$60.00		
Less: discounts taken on purchases	36.00		
Loss on purchase discounts		24.00	
		$1,164.00	
Less:			
Inventory, 100 units at $1.14 (cost)		114.00	
Gross merchandising cost			$1,050.00
Gross profit on trading			$ 250.00

Now let us compare these results with what is usually shown. The ordinary trading statement would be somewhat as follows:

Income statement for month ended December 31st

Sales, 900 units at $1.50		$1,350.00
Less: sales discounts		50.00
		$1,300.00
Contra:		
Purchases	$1,200.00	
Less: purchase discounts	36.00	
	$1,164.00	
Less: inventory (100 units at $1.20)	120.00	1,044.00
Gross profit on trading		$ 256.00

Instead of a $17.50 profit because of allowable discounts collected from customers, this latter statement shows a $50 loss from sales discounts; and instead of a $24 loss because of neglected purchase discounts the management is priding itself because of a $36 profit. The inventory, which will appear in the balance-sheet, is 5 per cent overvalued in the latter statement. Real information concerning the ability of the business to take advantage of its discounts is shown in the former statement; the latter statement tells only one side of the story and the less important side at that. Concerning allowable discounts on sales, the former statement tells how many of these the business has succeeded in collecting, while the latter statement gives no information at all that would enable the management to keep in touch with this possible source of profits. The recording of possible discounts gives to the management and to the stockholders of the business information concerning certain conditions existing within the business that it is essential for them to have, yet the obtaining of that information, as outlined in the above simple scheme, is comparatively easy. The point to be remembered is that it is not the purchase discount taken which is so important from the standpoint of the management as it is the discount not taken, for the failure to take advantage of purchase discount may reflect an insufficient amount of working capital or other inherent weakness in the financial condition of the entire business.

Factory Costs*

By L. T. Konopak

While it is true that certain principles underlie all factory cost systems for the same industry, it is equally true that no one system will fit all the factories in that industry. The forms used and the manner of accumulating the detail must be governed by the physical operations and the production methods employed, which differ in practically every factory even though the same product is manufactured. The cost system described in the following pages was designed for a factory manufacturing transmissions, and the only claim made for it is that it fits the conditions of the particular factory for which it was designed, but not the industry as a whole. It was designed for a factory making its first step toward efficiency, and an attempt was made to avoid complications, which would discourage further efforts.

The forms provided for reporting the various transactions of the factory were designed to facilitate handling the clerical work in a routine manner with the least consumption of time.

It is imperative that the men employed in the factory be impressed with the importance of the system, for the cost records are based entirely upon reports issuing from the factory employees. When a new cost system is installed various difficulties are encountered and its introduction is sometimes opposed by the employees, for the system may mean a curtailment of privileges, closer supervision and more effective work—all of which are advantageous to the plant. Possibly some minor points of the system as first installed will require revision in the light of new developments, but there is no doubt in regard to its successful operation if supported by the management.

By keeping the physical operations of the factory in mind this report will be easily comprehended, for the cost system merely records them in dollars and cents . The ease with which costs are accumulated depends entirely upon the manner in which the factory is operated. The records must follow the same routine as the production, and if the production is thoughtfully and systematically

*A thesis presented at the May, 1920, examinations of the American Institute of Accountants.

planned the records will naturally follow in the same order—and, of more importance, the production costs are then at a minimum.

The accounting of the company is divided into two distinct classes, segregating all expenditures for production, constituting factory costs, in one group of accounts and the expenditures for general administrative and selling expenses in another group of accounts. The factory cost includes all items incident to the manufacture of the product and may be further subdivided into direct and indirect costs. The direct cost of an article includes the cost of all material that goes into it and the labor cost of the men performing the work. The indirect costs include all items which can not be charged in entirety directly to the article being manufactured, such as supervision, power, depreciation and all other items of expense necessary for the factory's operation. Indirect cost is generally called overhead and will be pro-rated over the cost of the various articles made in the factory in proportion to the direct labor consumed in their production.

The operation of the system will be started with a complete inventory of all raw material, material in process of manufacture, finished parts and assemblies. The inventory of the work in process will be posted to the cost sheets for the respective part numbers, and the raw material, finished parts and assemblies will be posted to the stock record cards.

When material is received in the factory it is reported on a receiving slip from which the quantity and unit cost are entered on the stock record. Material returned to the shipper is reported on a return purchase slip and the quantity is deducted from the balance on hand as shown by the stock record.

When the manufacture of each quantity of a part is started, an identification tag is fastened to that particular group or lot showing the lot number, part number and the quantity started. The bottom of the tag contains a requisition, on which the material used is recorded, which is then detached from the tag and sent to the cost department, where it is priced, charged to the cost sheet and credited to the stock record.

The cost of all work performed in the factory is accumulated on cost sheets, which are carried for each part or assembly of parts or for orders to cover various expenses and work other than regular production. The part number is always recorded by the employees of the factory when reporting work performed or ma-

terial used in the manufacture of a part or assembly of parts. When working on a part, the lot number shown on the identification tag is also reported. If work, for which orders are provided, is performed the employee designates the order number on his time report in the place of the part number.

The parts made in the factory will be entered on the stock records from the cost sheets and those used in assemblies completed during a month will be determined from specifications of parts required and reports from the factory of the quantity of assemblies completed. It will not be necessary for the factory to make requisitions for parts used in assemblies.

However, as parts are found defective when fitting them in the assemblies and as only the parts required according to the specifications are charged to the costs, it will be necessary to return to the stock room all material found defective, and the stock-keeper will report it to the office on a defective material report from which the stock records will be credited. When entering the receipt of such material on his reports, the stock-keeper will segregate it according to the disposition he will make of it. That is, he will group the material to be scrapped on one report, the material to be repaired on another and the material to be returned to the shipper on another.

Each employee will record the time he spends on each job on which he works during the day, whether he is paid on a day rate or piece rate. The daily time tickets are to be approved by the foremen and sent to the cost department, where the rates and extensions are entered and they are then posted to the cost sheets and payroll.

The inspector will make out the piece-work ticket in duplicate, giving the carbon copy to the employee as a receipt for the work. The original is sent to the cost department where it is priced, extended, entered on the employee's daily time report, posted to the cost sheet and filed according to part and lot number.

As stated before, all parts being manufactured in the factory are identified by a lot number designated on a tag attached to one of the parts and as the work progresses the clock number of each employee performing any operation on the part, the number of the operation performed and the quantity completed and passed by the inspector are entered on the tag. The advantages of this tag are to aid the inspector in determining the correct count, to

avoid errors of paying more than once for performing the same operation on the same part and to insure a report of the material used for the cost records.

If the employee does not complete, before quitting time, the lot passed to him, only the quantity actually completed will be entered on the tag at that time and the balance will be entered when completed. If it is desired to break a lot and send some through ahead of the remainder, the quantity on the original tag should be changed to agree with the quantity left behind, and a new tag, bearing the same lot number as the original, should be attached to the parts sent through ahead, and the quantity, operator's number and operations should be recorded thereon for the parts in that group.

The costs are accumulated on sheets segregating the material, the labor for each operation and the overhead. A separate cost sheet will be used for each part number and the number of lots for the same part grouped on one sheet will be determined by the cost department. By recording the lot numbers for the material used and the labor for every operation, it is an easy matter for the clerk posting these sheets to determine any discrepancies in count. When a cost sheet is closed, the costs are totalled and reduced to a unit cost which is transferred to a comparative cost record. In time this record will be valuable to indicate fluctuations in costs, but the final analysis must be made from comparison of the original cost sheets.

All material used for assemblies will be credited to the stock record and charged to the assembly cost sheets from specifications of parts required and will not be reported on a requisition from the factory. The assembly labor is posted from the time tickets and, upon the closing of the cost sheets, the overhead is added to ascertain the cost of the completed articles. They are then entered on stock cards from which they are credited when sold.

There is a considerable difference in the overhead per hour or dollar of labor for the various departments in the factory, which becomes evident by comparing the equipment used by a man at a bench with a few tools and an electric light with the man at a machine costing several thousand dollars which requires expensive repairs, power, oils, etc. Therefore, all the individual expenses of a department will be charged directly to it and the remaining items of overhead will be pro-rated to the various departments in pro-

portion to the benefits which they receive therefrom. Separate overhead rates will be determined for each department by dividing the total departmental expenses by the number of its productive labor hours.

Description of Forms

Receiving slip. A separate receiving slip, made in duplicate, is used to report all material received on each purchase order number. Both copies are delivered to the office, where the duplicate remains for the office files. The unit prices are entered on the original, which is then delivered to the cost department and the quantities and unit costs are posted therefrom to the stock record card, indicating the receiving slip number in the reference column. The original is then filed according to number in the cost department.

Stock record. A separate stock record card is used for each part to perpetuate the inventory, and the quantity of each part on hand and its cost when the inventory is taken will be posted to the respective cards. The material received for stock is added to the balance on the stock record cards from receiving slips, from defective material reports of material to be stocked or returned to shipper and from closed cost sheets. All raw material used is reported by the requisitions detached from the identification tags and the quantity so used is entered on the stock record and deducted from the balance on hand. Finished parts used in assemblies are deducted monthly in total for quantities as shown on assembly cost sheets. Parts used for customers' repairs—charged or gratis—are deducted as reported.

Identification tag. Each lot of a part manufactured is to be tagged and identified by the lot number on the tag. If it becomes necessary to divide a particular lot of parts and send some through ahead of the others, an additional tag bearing the same lot number will be used. The requisition attached at the bottom of the tag should be properly filled in, stating the quantity of material used, the part number of the completed part and the number of pieces started. This requisition is delivered to the cost department and the quantity of material used as designated thereon should be credited to the stock record card. The unit and total costs are then entered on the requisition and posted to the cost sheet for the part number designated. The requisition is then filed according

to lot number until the end of the month when an adding machine list is made and the total cost shown thereon is charged to work in process and credited to the stock room.

The inspectors or employees should record the operation number, quantity completed and passed by the inspector and the operator's number in the spaces provided on the identification tag. When the part is finally completed the tag is sent to the cost department as notification.

Defective material report. All material which is defective, due to poor workmanship or other causes, should be returned to the stock room. The stock-keeper should make daily reports to the office of all such material received, stating what disposition will be made of it. Such material as castings, etc., if returned to the foundry before any work has been performed upon them in the factory will not be reported on a defective material report; but if an operation has been performed on the material and it is then found defective the stock-keeper should report the receipt of such material. Separate reports should be used to report the material to be scrapped, repaired for stock and returned to the shipper, respectively. The cost department will enter the costs on these reports and credit the various cost sheets to which the material has been charged. At the end of the month they will be summarized to show the total cost of parts scrapped, repaired for stock and returned to shipper.

Return purchase slip. All material returned to a shipper is recorded on a return purchase slip in duplicate. The carbon copy is sent to the cost department and the quantity shown thereon is credited to the stock record card. The original is delivered to the office and an invoice against the original shipper is made therefrom.

Report of material used. Frequently material purchased for the manufacture of the company's product will be used for other purposes, such as making new tools, repairs, etc., and it should be reported to the office on the report of material used. The quantities thus reported are credited to the stock record and the report is priced, posted to the cost sheet and filed according to order number until the end of the month, when the total cost is obtained and charged to work in process, crediting the stock room.

Piece-work ticket. Piece-work tickets are to be made by the

inspectors, reporting on a separate ticket each kind of part worked on during the day by the operator. These tickets are to be made in duplicate; the original is sent to the office and the carbon copy is given to the operator as a receipt for the work. In the office these tickets are priced, extended, checked with the employees' daily time report and posted to the cost sheet for the part number designated. They are then filed according to part number.

Time report. A daily time report is to be approved by the department foreman for each employee. It will show the disposition of his time for the entire day, whether piece-work or day work, and the part number or order number, etc., on which he worked. In the office these tickets are extended, entered in the payroll book and posted to the cost sheets. They are then filed according to the employees' clock numbers and accumulated for each pay period.

Cost sheet. A separate cost sheet is used to record the cost of manufacturing each part, assembly or work performed on orders. These sheets are filed in a binder according to part number or order number. When the requisitions are posted the lot numbers are also entered in the space provided on the sheet as a check against incorrect labor postings. The posting of time tickets is segregated to show the total labor cost of performing each operation on the part. When the cost sheet for a particular part is closed, overhead is added and the totals are summarized and transferred to the comparative cost record. The quantity completed is posted to the stock record cards for finished parts or assemblies. The cost sheet is then withdrawn from the current file and the total of all closed orders is charged to the stock room and credited to work in process. The charges accumulated on orders will be closed each month by charging the respective expense or asset accounts and crediting work in process.

At the end of each month the cost sheets are proved by trial balance with the controlling account carried in the general ledger.

Comparative cost record. A separate comparative cost record is kept for each part number and the costs accumulated on a cost sheet are transferred, when the cost sheet is closed, to the comparative cost card.

Assembly cost sheets. The cost of assemblies completed is computed on an assembly cost sheet on which the parts required

are listed in detail. The stock records are credited with the parts used, and the unit and total costs are entered on the assembly cost sheet. The assembly labor and overhead are then added. The total quantity assembled is entered on the stock record and the total cost of assemblies for each month is charged to finished product and credited to work in process. These sheets are then posted to the comparative cost cards and filed according to part number for further comparison.

Monthly Journal Entries

The following journal entries, necessary to prepare the general books for the compilation of the monthly financial and profit and loss statements, are to be made by the cost department and given to the general bookkeeper:

Dr—Work in process
  Cr—Raw material stores
Total cost of raw material used, taken from requisitions detached from identification tags.

Dr—Raw material stores
Dr—Material spoiled and scrapped
  Cr—Work in process
Total cost of material found defective in process of manufacture as shown by summary of defective material reports.

Dr—Work in process
  Cr—Raw material stores
Total cost of material used as shown by reports of material used.

Dr—Work in process
  Cr—Overhead distributed
Total overhead as shown by manufacturing expense accounts in general ledger.

Dr—Finished parts
  Cr—Work in process
Total cost of parts and assemblies completed as shown by cost sheets.

Dr—Various accounts, as designated on special orders
  Cr—Work in process
Total cost of special orders closed.

Dr—Work in process
    Cr—Finished parts
Parts used for assemblies as shown by assembly cost sheets.

Dr—Finished product
    Cr—Work in process
Total cost of assemblies completed, from assembly cost sheets.

Dr—Cost of sales—repair parts
    Cr—Finished parts
Total cost of parts used for repair orders charged to customers.

Dr—Gratis repairs
    Cr—Finished parts
Total cost of parts used for repair orders gratis to customers.

Dr—Cost of sales
    Cr—Finished product
Total cost of transmissions scld.

Information Desired by the Banker*

By Julien H. Hill

In the invitation of your committee to talk to you this afternoon, you have given me an opportunity to say in all sincerity what seems strange from the lips of a banker: "I am delighted to be surrounded by so many bank examiners." Bank auditing is properly an important part of your professional work, even though it be not so remunerative as other branches. It is also gratifying to me to be assured of the fact that, however, far short I may fall of what is expected of me to-day, I, at least, as a banker, have the privilege of exacting interest for once from my auditors.

The banks of this country are becoming more and more dependent every day on your profession and we often wonder how our business was conducted without you. It is with special pride that we regard the Virginia Society of Public Accountants, and I can assure you, certainly for my own part and I feel that I can speak for the majority of my fellow bankers, that the spirit of coöperation which you have shown is most heartily reciprocated.

To this end, I shall try to give you, in a very general way, the manner in which the banker who is not expected to be a professional accountant reviews the reports prepared by you.

Possibly the phases which I shall attempt to cover may suggest to you some method of standardizing as nearly as practicable the reports of your audits. Of course, I realize that many obstacles are encountered by you in making uniform reports; but the fact that you can say to your client that certain vital information must be incorporated if the statement is to be submitted to his bank as a basis for credit may help you to surmount such difficulties.

When the audited statement of a firm or corporation is presented to the officer handling that particular account, his first and casual perusal of it will include, primarily, a careful reading of the preamble and comments of the auditors, thus ascertaining the

*A paper read at a meeting of the Virginia Society of Public Accountants, Richmond, Virginia, September 4, 1920.

scope of their examination. Next, the statement of assets and liabilities will be scrutinized with special regard to the ratio of quick assets to current liabilities. Here let me say that it is always very helpful to the banker if these items with their proper subtotals are given first and the fixed items last.

Next for observation is the operating or profit and loss statement for the year. Unless reports have been made at stated intervals to the bank, it is vital that a comparison with previous years or at least the previous year be given in your report. This is equally true of the asset and liability exhibit.

These two statements are in a general way the guide to the banker in analyzing the credit standing of his customer or prospective customer; and in former days this was frequently considered ample information. But with changed conditions, with the vast amount of saving to be effected by employing proper methods of accounting, with the research now being made to determine ratios in every line of business and their proper application and, most vital of all, with the complex conditions of the business world at the moment, the banker is "from Missouri" and wants an exhaustive audit. He doesn't always get it, but I am inclined to think that in a few years your clients will themselves realize that a partial examination of their affairs is poor economy and will themselves have nothing less than a complete report.

With existing conditions two asset factors are of utmost importance: the inventory and the accounts receivable. Close attention should be paid by you to the methods of determining the inventory figures given you (and I hope the time will come when the cost of an appraisal by experts, associated with you, will not be prohibitive). When the inventory is not made directly under your supervision, you can greatly assist us in your comments, in telling us, first, how it has been reported to you that the inventory has been taken and whether in your opinion the methods used tend to accuracy. When a partial checking (as to larger items by means of invoices, for instance) is made by you, it should be so stated in your essay. Frankly I think you owe it to yourselves, to your client and to his bank to be explicit on this item, especially if you have any reason to suspect in any degree overvaluation or undervaluation of merchandise of whatever nature. And in these days of transportation difficulties, with goods to be paid for

long before arrival, please tell us fully about goods in transit. Careful analysis of all accounts and bills receivable, segregated as to current and past due, should be furnished for the benefit of the bank. It aids the banks very much to have the ratios worked out on these items, but, of course, these ratios are not essential.

At present, it is also very important to the banker to see itemized schedules of accounts and bills payable. These are the principal points to be emphasized as to the elaboration of the information on items hitherto scrutinized less carefully.

But bear this in mind—the banker prefers always the best report that can be obtained and to my mind an examination should never include less than

1. Introductory comments and criticisms pro and con of each exhibit.
2. Statements of assets and liabilities with the arrangement of current assets and current liabilities first, under their respective debit and credit headings.
3. Operating or profit and loss account, preferably with comparison with figures for same date of previous year, and in view of present practices (entirely legitimate, as I regard them) an itemized list of officers' salaries.
4. Accounts receivable, in detail showing which are past due and how long past due, when not widely distributed or very voluminous.
5. Bills receivable and trade acceptances with contingent liability on items rediscounted.
6. Accounts payable, showing separately current accounts and any accounts past due, when not too voluminous.
7. Bills payable, scheduled in detail.
8. Capital stock, detailed list of stockholders with respective numbers of shares held, when the corporation is a "close corporation" or when the stock is not widely held.
9. Insurance, bonds, etc.

It would be of great value to the banker were the accountants to include in their comments, in addition to remarks as to depreciation, reserves, etc., any general information as to the general conduct of the business having any bearing whatever on the financial

soundness of the firm or corporation under review, not ordinarily reflected in the figures. This is a broad request, but it might be borne in mind, so that when consistent such facts could be incorporated.

Under this general heading, I might mention the value to us of information as to the accuracy of the cost system, the commission, bonus or profit-sharing plan, which, though outside the range of an audit, are nevertheless phases of a business that come to the attention of the accountant and are frequently of considerable importance to the banker. Again I want to stress the need of close scrutiny of and comment on the methods of providing for depreciation and other reserves.

In addition to the schedules enumerated, it is customary with some accountants to give other ratios. I might add that many of the banks, in their analyses of statements, frequently determine for their own purposes ratios of (a) worth or capital to fixed assets (to determine if too much capital is invested in plant); (b) receivables to merchandise (as merchandise converted into receivables takes a profit into the statement); (c) sales to receivables, to gauge the promptness of collections; (d) sales to merchandise, to ascertain the turnover; (e) sales to worth, to show the turnover of capital; (f) profits to sales, for obvious reasons.

I mention these ratios because of the assistance they may render your client if made a part of your statement from year to year. While, of course, in using them for comparative purposes, the ratios are determined by us from statements of other customers in similar lines of business, which we have on our books, you can readily see that with the much broader field represented by the many examinations that you make in various lines you are able more nearly to get the barometric figures. Such figures for qualitative purposes in your reports should invariably work to great advantage to your clients.

The audited statement is daily growing in importance in determining the extension of credits, but there are thousands of concerns which have yet to appreciate the advantages accruing to themselves as well as to their banks, and I do not hesitate to tell you that we are daily advocating the value of periodical audits by certified accountants, and I rejoice to see that even among the smaller banks the audited statement is now recognized as of first importance.

Probably, from the standpoint of the plain, every-day banker, I have touched upon some angles of the statement analysis that are more technical than the subject assigned me should cover. Not all banks are yet so fortunate as to have on their staff one of your profession, as is the case with our bank, and consequently they do not attempt to dig quite so deeply as we do. Yet there are many points (exceptional, I grant you, and specific rather than general) which it would be interesting to discuss, if time permitted.

There is only one criticism which I want to make as a part of this rambling talk, and it is so succinctly set forth in the July issue of THE JOURNAL OF ACCOUNTANCY that I shall read it in full:

> A recent issue of THE JOURNAL OF ACCOUNTANCY contained editorial comment on the misuse of accountants' certificates. Attention was drawn to the danger which lies in the publication of a portion of a certificate or financial statement without the context.
>
> The most notorious incident on record of the perversion of the written word by omission is Bismarck's mutilation of the Ems dispatch, which induced the Franco-Prussian war. All decent men everywhere damn the iniquity of that offense; yet men overlook the comparatively unimportant criminality which attaches to the omission of essential statements in a financial report. Such an offense seems insignificant compared with an international incident, but the principle, or lack of principle, is the same. No essential phrase or word or punctuation mark should be omitted if by such omission the intent of the writer is distorted.
>
> Accountants are awaking to the danger which lies in condensation of their reports, and some of them are insisting upon a clear, full reproduction of their original certificates and statements.
>
> A method adopted by one prominent firm is worthy of consideration. Every report emanating from that firm bears the following printed note:
>
>> "The publication of any condensation or modification of statements herein contained, or the use of our certificate detached from its context, or the use of our name in connection with the sale of securities or other publicity, will not be sanctioned unless first submitted for our approval."
>
> This limitation upon the use of an accountant's report, if generally adopted, would go far to prevent deception of the public, such as is too easily effected if financial statements be published in any form not fully reflecting the facts.

Perhaps all of you have read this. I trust and believe that none of you has pursued the policy thus condemned. Even though you furnish a statement of assets and liabilities separate from the detailed report you should indicate that it is a part of a detailed report, so that the banker will be put on notice that a complete audit has been made.

To make up a balance-sheet for general use without an examination—well, I'll not insult your intelligence by remarking on this.

In conclusion let me say that as vital as is your work to the banker, it can never be the final word for him in determining credit. Remember those four basic factors: character, capacity, application and capital. Sometimes it is quite difficult for the accountant to understand the banker's viewpoint. If this happens with you, talk it over with him. He wants your criticisms and maybe he can occasionally change your way of thinking or vice versa. He is always open to conviction. And a closer relationship between the men of your profession and of ours cannot but tend to safer and saner business methods and constructive work along many lines.

Accounting for Income in Eleemosynary Institutions*

By Percy D. Mitchell

Attention in industry as in the home centers to-day around the high cost of living and stereotyped as its discussion has become it will not cease to hold our interest until its effects have been dissipated. In most manufacturing and commercial industries selling prices have, in true accord with economic laws, kept pace with purchase and productive costs and thereby have maintained income ratios. Actually such concerns have increased profits, speaking generally, but are perhaps no better off if those profits are measured in terms of purchasing power. Naturally the stockholder as such finds himself in much the same position, though perchance conservative directors, having in mind probable days when demand does not so greatly exceed supply, have for the time being sacrificed him for the benefit of the corporation.

But what of those corporations, institutions, estates and individuals whose income largely arises from long-term investments relatively safe and of correspondingly low returns? Where such investments are found, an income which has not varied with rising costs exists. Money values have changed, to be sure; but with that change has fallen the value of many strong investments to the point where the loss which would attend their sale offsets any advantage in income that might attend current purchases. Thus not only has the income of these concerns not increased in purchasing power but also no increase has occurred when measured only by the dollar.

Among such unfortunates are banks and eleemosynary institutions. Of banks the smaller, particularly state banks, such as those devoted entirely to savings deposits, have suffered most. Trust companies and national banks have benefited by the increase in successful business to an extent partly offsetting rising

*A thesis presented at the May, 1920, examinations of the American Institute of Accountants.

costs. But the less liquid savings bank has found its only relief in increased deposits which have enabled it to purchase at the present advantageous market. But little immediate benefit has been derived as, excluding amortization, it must wait for much of the increment so obtained until the purchased securities mature. On the other hand its expenses, for the most part small, consisting largely of salaries, have been slow to increase.

But in the case of eleemosynary institutions costs have mounted rapidly while the large portion of income derived from securities has not followed suit. With them the ratio of income to expense has become an acute question. It is therefore pertinent to consider their income accounting.

Further reason for inspection of accounting for income exists at this time because of the approach of a period of depression which economic history indicates will follow present expansion of production and inflation of values. That such a period may be particularly grievous is deducible from the already strained conditions of transportation corporations and public utilities generally. Probably more than fifty per centum of the income from securities held by savings banks and eleemosynary institutions is derived from such corporations. Foresight therefore demands preparation for properly recording income due, but unpaid—income in arrears.

Inasmuch as the scope of this thesis scarcely allows for developing in detail the peculiarities and necessities of more than one accounting system, directness of treatment will from this point be applied only to eleemosynary institutions and of them only to the college or university. It is hoped thus concretely to present a method of accounting for income which will admit of ready adaptability to other institutions and to banks and other organizations where income from securities is a considerable item.

Income accounting might be construed to cover many forms of income based on the various sources from which it comes; but each form has its own peculiar problems. For that reason, discussion here will be limited to that income which is derived from securities such as stocks, bonds and mortgage notes. Income from rents may be considered as included if it be borne in mind that supporting statistical information is more important relatively than in the case of bonds, for instance.

There are several methods in use for accounting for these

incomes: cash, accrual and amortization combined with the accrual method. And there is another method which combines the cash and accrual methods. For the purposes of this discussion amortization will be considered only by saying that in ordinary circumstances its practical application is doubtful for the three reasons that it requires time which institutions can ill afford; that it accrues income that may never be received; that it accrues income the cash from which is not available for expenditure.

The cash method is most widely used, for it meets effectively those difficulties which amortization encounters: it is simple, requiring a minimum of time; it is certain, meeting all demands of conservatism and in no way forestalling donations by income inflation; and lastly it does not record the income until it is available for use. This last is important for the income of institutions is rarely adequate. Indeed someone has said that no self-respecting institution would operate without a nominal deficit. And where the income, as it frequently is, is wholly or partly restricted, the cash method is nearly imperative.

On the other hand the cash basis alone is inadequate. Granting its advantages of ease of operation, conservatism, availability for use—the question next arises: Does it properly safeguard receipt of income?

Certain it is that any system of accounts which does not take cognizance of all important details is inadequate. Inadequacy is particularly reprehensible in institutions, recipients of charity; and in no other type of organization, excepting possibly banks, does incompleteness bring its dire results so surely. Thus, through defective accounting a manufacturing corporation suffers a cashier to embezzle a certain sum of money and measures its loss by that sum. Its sales or income are in no other way affected. But let a charitable institution through no more neglectful methods stand such a loss and its goodwill in obtaining donations is impaired for an indefinite period.

Where income is actually received regularly when due, the cash method does supply a fairly safe record. But where such items are numerous and defaults occur the cash method fails to leave a clearly defined record of arrears. This objection may be met by accruing the income as it becomes due; but this method encounters two of the difficulties already discussed: the income is inflated and it is unavailable. Moreover it creates the impres-

sion of availability and it inflates the income at the time when there is the least probability of its being received.

There remains for consideration, then, the other method which combines the cash and accrual ideas. In practice some attempt is often made to use this method in a sort of hit-or-miss way, but rarely is it found an integral part of the accounting. Nevertheless it can be applied without unduly increasing the time and labor of bookkeeping, without inflating income, and without distributing income until it is available. Furthermore, it will supply a complete record—and that which is complete can scarcely fail to be adequate.

There are two other desiderata which combining the cash and accrual methods supplies as well as or to greater extent than either method alone: continuity and availability. The very nature of the income accruing in regularly repeated intervals in the same amount requires a continuous record to be properly intelligible to financial committees and other trustees of institutions, frequently so busily engaged with their own affairs that only perfunctory or occasional attention is given to affairs of trust. Thus even an auditor's report that certain income for the year just ended has not been received will be noted for the moment but will not be followed up during the current period. To effect continuity all income not received must be carried forward to following periods.

Such a continuous record is easily available both to officers and to auditors. If all the income that could possibly be received has been charged, one account can be used to indicate that fact. The treasurer, trustee or other officer can determine the status at a glance. The auditor, too, can readily check the whole matter; whereas under the cash method he must somehow build up the accrual method to insure completeness. It may not be axiomatic but it is a fairly safe rule to follow that that method which audits most readily has superior qualities.

In effect, combining the cash and accrual methods means that although the income is accrued as it matures, it is not distributed for disbursement until it has been actually received. The formula for accomplishing this is two-fold: (1) make the accrual method an integral part of the double-entry accounting: (2) arrange the income register to account as well for principal as for income. In other words the income register should be a detail investment ledger to the extent that it records in every instance changes in

principal and is the basis of double entries re matured income. Indeed, in institutions with several millions involved, it may when supplemented by proper statistical records serve as the investment ledger, and that ideally, because combining simplicity and small amount of labor.

To make accrual accounting an integral part of the double-entry system it is necessary to charge the accruals to some balance-sheet account, with the stipulation that a reversal of the entry may not be made except by express vote of the finance committee or trustees. In other words, it is not enough to use memorandum accounts: i. e., offsetting debit and credit accounts which are eventually eliminated by simply reversing the originating entries.

The method to use can be best explained by illustration.

(a)	Income receivable,	xxx	
	To income matured,		xxx
(b)	Cash,	xxx	
	To income receivable,		xxx
(c)	Income matured,	xxx	
	To sundry income accounts,		xxx

By this method income receivable is charged, entry (a), with all income as it matures. That account is then accountable for in cash, entry (b), and no other credits should be allowed except by recorded vote of finance committee or other trustees. Income receivable may sometimes and after a period probably would contain two elements, income receivable in arrears and income receivable to be received or slightly delayed. Distinction, of course, should be drawn, and to that end the trustees once a year might authorize transfer to a separate account of that income in arrears which it is believed will scarcely be received soon if at all. Such income would be that from bonds of corporations in default and undergoing reorganization and from mortgages in process of foreclosure.

Here a word may be added regarding the advisability of accruing income after default. It is maintained that, if it is not distributed for disbursement, it should be accrued, for that is the very essence of the problem and to lapse at such a time would impair the method to the point of making it almost futile. Until otherwise authorized the treasurer should be accountable for all the income from a security exactly as if the debtor corporation

had not defaulted. And, since income is not distributed for disbursement until received, no false hopes are developed. Many reorganizations arrange to pay the income in default either at a reduced rate or in securities. Where the medium is securities, care should be used in their valuation for entry.

But it is not enough that the income register be the basis of the double-entry income accounting. If it does not serve the further purpose of an investment ledger it must be self-demonstrating that its totals both par and book agree with the investment control or balance-sheet just as truly as a ledger does. This statement would seem so axiomatic that it need not be emphasized; but in practice such correlation has been found lacking. This important deficiency has in such instances appeared to result either from incompetency (failure to understand the importance of such correlation) or from faulty methods. By this phrase is meant the inadequacy so frequently found as the effect of old methods, once sufficient perhaps, but now outgrown. Endowment funds have grown largely during the past two decades and not always has the accounting therefor kept the pace.

In still another way should the income register be tied to the balance-sheet—the income matured and unaccounted for currently must be properly forwarded, the balance forward agreeing with the debit balance of the balance-sheet account income receivable which was charged by entry (a). It is not enough simply to leave blanks, unchecked items, etc., to represent income in arrears—each period's deficiency must be carried forward and charged to the period following. This may be done by summarizing the debits and credits for each period and forwarding arrears as one does a cash balance or by arranging the register so that the columns provide the necessary balance plainly without summary.

At this point consideration may be given to the inclusion of arrears income in the balance-sheet as a policy of the institution. For internal purposes—for the treasurer, finance committee, president, auditor and others—there seems every reason for its inclusion. But where it is the custom to print and to distribute a treasurer's report which ought—though frequently like those of municipalities it does not—to contain a balance-sheet, objections may be raised that such inclusion might by giving impressions of a financial prospect more hopeful than warranted and of mismanagement forestall donations. This is serious reason but of

doubtful weight. It is to be assumed that such balance-sheets are of interest primarily to an intelligent class of people who should for the most part be able to read properly a well expressed balance-sheet. If, then, care be used to indicate clearly the nature of the item of arrears income and its corresponding reserve, no misunderstanding ought to arise. Or if anything further be thought necessary, brief comment in the written report might explain.

Attention to the position of income receivable on the balance-sheet will do much to avoid misconceptions. On the asset side it should be analyzed, as already mentioned, to show current income overdue and arrears income the receipt of which is doubtful, the former being a current asset and the latter an item of suspense or contingency. On the liability side, the credit account income matured but not received may appear as deferred income if the item be current; but, where the debit or portion thereof is carried as suspense, a corresponding portion of the credit should be used as a valuation reserve. Careful consideration of attendant prospects of receipt will determine which position is preferable.

As to the question of suggesting mismanagement, if mismanagement has occurred, the potential effect of publicity might prevent its recurrence and, while there might be exceptions, incidental publicity such as would accompany distribution of a balance-sheet should be given, unless well founded reasons can be assigned for not doing so. But it should be clearly understood that an arrears balance not unduly large does not indicate mismanagement necessarily, for the very nature of the income under consideration implies the risks of judgment.

Inherent in the correlation of the income register and the balance-sheet is the problem of handling the so-called uninvested portion of funds. Frequently this phraseology is used to designate investment of a temporary nature such as savings deposits, certificates of deposit and the like. These deposits occurring at the inception of a fund, at the time of addition of a portion of the income, at the maturity of some investment, or of some portion, as in the case of serial bonds and part payments on mortgages, and at the time of investment by reason of the purchase price not exactly coinciding with the amount available for investment, usually are made only until fit opportunity for more permanent investment is found. But since such underinvestments frequently produce income, they should be handled exactly as investments

for longer terms. In fact, whether they produce income or not, they are accountable in the usual way for the two reasons that they are potential producers of income and that the income register must be in continuous accord with all balance-sheet figures appertaining to investments. It is to be noted further that such items as result at times of investment from the fact that purchase prices fall somewhat short of the uninvested cash available are often quite as permanent as the investment, but are usually small.

To accomplish proper recording of such uninvested portions care must be used in segregating them according to funds. In the case of a larger amount this separation should be made by the actual deposit of the cash by itself as well as in the accounting records, although it is expected to retain its integrity for only a short time. Even where the items are small, such segregation should be made on the books, but it may be found impracticable to keep eight-cent cash balances separate or to account for the income on each two dollars separately. The process of consolidation should, however, be employed sparingly and with discretion.

Proper attention to details as outlined in the foregoing paragraphs should leave a record of all income that ought to have been received and thereby supply an adequate basis for proving that it had been received. It remains to record as accurately its distribution after receipt. It is not within the scope of this thesis to deal with voucher systems and the like supporting the actual disbursement of the income received, but rather to study at this point the condition attending the entry appearing above as transaction (c):

Income matured,	xxx	
To sundry income accounts,		xxx

The function of this entry is to distribute among the various income accounts the income to which they are entitled when it has been received. By income account reference is made to the elemental income account of that triad fundamental to all fund accounting: fund, investment, income. The relationship of that triad entitles the income account to all the income received from the investment. (The word "received" is used advisedly, on the basis of the preceding discussion of the relative methods of recording income accrued and income received.) And, when that has been accomplished by entry (c), the same relationship entitles the

same income account to an explanation of the use of the income. In other words, disbursements under the fund may be made only as directed by the conditions of the fund and when so made are chargeable to the income account. A bookkeeping detail is met here: i. e., where such disbursements are numerous it is often expedient to charge them directly to a special account or accounts which are later in total closed to the income account.

These charges to income account are sometimes by the terms of the fund carried to principal or are payments to beneficiaries subject to life interests. The latter present no problems within our present discussion, as the payment ordinarily terminates the transaction; but the former supplies some of the cash mentioned above as uninvested. Auditors should note here that investment of this cash or its deposit at interest should follow the date of its receipt very closely.

Charges other than those just mentioned will for the most part present no accounting difficulties. Nice judgment may be required to satisfy the conditions of the fund, for all manner of limitations are frequently employed; but, important as strict adherence to these restrictions is, they do not affect the accounting methods as a rule.

Sometimes, however, such income is distributable by appropriation. In such cases the appropriations, if numerous or involved, should be charged against the income account and carried as appropriations are usually carried. Care should be exercised that any balance of such appropriations is carried forward, returned to the income account or otherwise properly handled as indicated by the terms of the fund.

After all charges, an unexpended balance sometimes remains. In some circumstances, as where more than ample funds have been provided for some specific purpose, an ever-increasing balance remains. It is important that the cash representing such balances be properly segregated and, where no immediate prospect of its disbursement is seen or where many such items exist at all times, demand deposit at interest seems to be required, the benefit, of course, accruing for purposes of the funds involved. In effect this adds a portion of the income temporarily at least to principal, an amount already more than adequate for current needs. In such circumstances when cash for general uses is short (and it usually is, and that properly in eleemosynary institutions) the objection

is sometimes raised that it is not good business to borrow at six per centum while there is available money either idle or earning but four. The objection has a practical sound, but until permission from the courts or from the donors has been obtained such infringement constitutes a breach of trust and should never be employed even temporarily.

It is thus seen that, since the disposition of the income ultimately depends on the conditions of the fund providing it, at no point in the accounting should the restrictions under which the fund is created be overlooked. By accruing the income when it matures, but distributing it only when received, conditions of the fund are readily met, and in addition a more complete check of income, continuous and easily available, is recorded. No inflation of income occurs, but no income, whether received or not, is overlooked.

Accounting for the Handling of Scrap Metals*

By F. A. Hamilton

The character of the scrap metal business is such that very little interest has been taken in it by the people generally, yet it has been developed to tremendous proportions—in fact the value of the gross business done annually aggregates many hundreds of millions of dollars.

To direct and conduct a scrap metal business might, at first glance, seem to be a simple matter, yet I venture to say that some of the keenest minds in the country to-day are interested to such a degree that they are practically devoting their entire time to carrying on this business.

When we consider the vast number of uses we find for iron and steel products alone, to say nothing of the other numerous metals or combinations of metals, we must agree that the business has become highly important. I should like to state the object of the business and a few of the peculiar accounting situations found in it. Let us consider the matter under the following classifications:

Object of the business aside from that of profit making.

The source of the metal. The purchase and sales contracts. The matching of one with the other and the accounting procedure incident thereto.

Operating statement showing the result of operation for the period.

Balance-sheet showing the financial position of the company at time of closing the books.

Object of the Business

The object of the business primarily is, of course, to conduct it in such a manner that it will earn a profit on the investment, but, aside from that, it would appear that the real object is to find certain grades of materials and distribute them to the numerous steel mills, rolling mills, foundries and other concerns for the purpose of reclaiming and converting this material.

It is a well-known fact that certain mills or foundries produce

*A thesis presented at the May, 1920, examinations of the American Institute of Accountants.

or manufacture only a specific product; therefore, their requirements as to raw materials must be met by furnishing certain grades of the various kinds of metals or mixtures in order that as little material as possible be lost in processing. As an instance, I might cite the case of a rolling mill which uses railroad car axles for the purpose of rolling bar iron. This is done with practically no loss of material. Or I might mention the case of a smaller business which purchases certain scrap metals and on refining them obtains Babbitt metal of various grades, white metal used by the printing trade in linotype machines, etc. There are also thousands of other instances where special requirements are supplied by the reclaiming of material in the scrap metal business.

Purchase and Sales Contracts

The purchase contracts are made with the idea of matching the sales contracts against them; hence it will be necessary to treat purchase and sales items under one heading so far as the contract accounts only are concerned.

Purchase contracts are entered into with large industrial plants, railroad corporations and others for the purchase of scrap materials to be delivered on order during a period of time and at a specified price. It is necessary, of course, to scrutinize a contract from time to time in order to learn whether or not it is being executed in accordance with the agreement; hence a record is provided on this contract for the recording of deliveries as to dates, tonnage and amounts.

There is also another method used by the company in purchasing material. A municipal plant may be bought outright; or a steam or electric railway may be bought as it stands. The miscellaneous material obtained through dismantling may be applied on sales contracts or shipped into one of the company's yards. It sometimes happens that the deal contemplated is too large for the company to handle alone, in which event the purchase is made on a joint account proposition, one or more other dealers coming in and sharing the expenses before the distribution of the profits is made.

Sales contracts are entered into with steel and rolling mills and many other concerns for the sale of the material, running into orders for hundreds of thousands of tons during a specified time, said material to be delivered with the full understanding

that the company is to be permitted to originate shipments anywhere in the country provided that the specified classification of material is maintained. A record is also provided on the sales contract showing deliveries to customers or dealers as to dates, tonnage and amounts.

Let us, at this time, consider the accounting procedure in reference to the direct shipments controlled by the purchase and sales contracts. At the time the shipment is made by the consignor, should consignor represent an industrial plant, it may be billed to the customer direct, or if the shipment was forwarded by a dealer and it is deemed advisable not to permit the customer, for various trade reasons, to know who forwarded the material, or to permit the dealer to learn the name of the customer, it may be billed to the company at delivery point, and the waybill may be sent to the office of the company, which in turn reconsigns the car. On the cars billed direct to customers orders are issued to the carriers authorizing delivery.

When shipment is made by the consignor, an invoice should be mailed to the company immediately. The purchase invoice, when received, is at once recorded in a book called the car record, showing the name of consignor, date, car number, contents, weight, etc. The car then being ordered out or delivery authorized, the purchase invoice is handed to the billing department, where a sales invoice is made out in duplicate against the customer for the identical material. When proper office references are noted on the duplicate invoice, which has become the sales book, the entry in the car record is completed by showing to whom the car was sold. The information necessary to be shown on the purchases and sales contracts, as to tonnage received and delivered applying on certain contracts, can at this point be collected.

When it is considered that anywhere from two hundred to four hundred cars may be handled daily and that a great many are rejected owing to overcharge in price or freight, short weight in tonnage or incorrect classification of material, or because perhaps the material is up to specifications but cannot be used by that particular mill, one can readily appreciate the necessity of correctness in handling this accounting feature of the business through the car record.

It must also be understood that many of the materials purchased are of a mixed nature and for a great deal there is

no ready market. Perhaps the opportunity to sell arises, but the material is so far removed that the freight charges prohibit the sale, as the profit would be consumed by the carrier for the handling. In this event, it is shipped to the nearest yard, the company usually operating some six or eight throughout the country. The same procedure as to entry in the car record as noted above regarding direct shipments is followed.

An important matter should be noted at this time. Many cars are rejected at destination or in transit, and this makes it absolutely necessary to act promptly in order to avoid payment for demurrage, storage and like charges by the carriers and others. This can be accomplished by diverting the cars to some other customer in that vicinity or to one of the company's yards, electing to reduce the price to the original customer by an understanding with the consignor that the purchase price be reduced correspondingly or the entire shipment be thrown back on the hands of the consignor, in which event an adjustment of some kind or other in regard to expenses incurred becomes inevitable.

At this point a difficult question sometimes arises as to the journal entry which will tell the story truly and correctly. As much material is bought and sold subject to acceptance or rejection on delivery, depending on certain grades or classifications, a great number of cars is rejected. The reason for this in many cases is that the material is not inspected by the company before or after shipment. Should the charges have been made against the customer on the books of the company and the invoice of the creditor be passed for payment, and in many cases paid, it becomes necessary to make a journal entry. Such entries would be formulated as follows:

Sales returns to customer	at selling price	
Creditor to purchases		at buying price

In addition to items mentioned above, a few others would have to be considered, such as equalizing freight charges based on certain points of delivery, controversies over scale weights and the like, so that it becomes evident that the journal entries should be made with care and good judgment.

There is another important matter attaching to the fulfillment

of the purchase and sales contracts. For many reasons it may become necessary to void the contracts either voluntarily or involuntarily owing to conditions within or without the company's control. Should the purchase contract be partly filled at the time of voidance some equitable agreement, if possible, is reached and settlement made either by payment of cash or otherwise. This settlement may run into large figures as the company would be compelled perhaps to go into the open market and purchase sufficient material to satisfy its sales contract at a much higher purchase price as well as a considerable difference in freight rates. Should the company decide to void a sales contract, for any reason, the company must make the best possible settlement with the customer.

Let us now consider settlements. The business so far as the material purchases are concerned is practically operated on a cash basis through the general books. The material purchase invoices as rendered by the company's creditors are vouched and passed for prompt payment, with the exception of certain interchangeable accounts or in case of dealers from whom the company buys and to whom the company sells. No account is kept of accounts payable in the general books during the year, with the above exception. In other words the operation of the business is not charged in the month in which the purchases are made unless paid for during the same month, but at the close of business for the year or period all unpaid invoices for purchases, expense items and freight charges are properly set up and offset against the revenue accounts.

The above comment refers only to the general office cash settlements. It has been found advantageous to operate in close proximity to the markets. In one case, some six or eight yards were taken over and eight or ten branch offices were opened throughout the territory. The business carried on by the yards and branch offices being done in a great measure for cash, it became necessary to provide funds for the yard and branch managers. Therefore, bank accounts were opened in each city and the yard and branch managers were authorized to draw cash vouchers against the funds, said funds being controlled by the general office. Accordingly, a uniform cash journal form was devised and adopted and each yard or branch manager was instructed to forward the duplicate sheets as fast as the pages were filled, together with purchase

or expense vouchers. At the close of each month, the canceled bank cheques or vouchers are forwarded, thereby enabling the general office to verify all disbursements for payrolls, expense or purchases. These cash journal sheets sent in by the yards or branches are balanced by the local cashiers or bookkeepers, making it necessary only for the auditor to formulate the closing entries. The records then become original books of entry from which all items are posted to the general ledger as to nominal expense or revenue accounts and to the various customers' ledgers as to those accounts. The control account carried in the general ledger must, of course, correspond with balance shown on the individual yard or branch office account.

In addition to the yards and branch offices, this company operates a subsidiary manufacturing proposition, one plant being located in the east and another in the west. The eastern plant is permitted to collect accounts and bank the funds but is not authorized to draw any cheques against such bank accounts; therefore all expense vouchers are sent to the New York office where the cheques are drawn on a local bank and returned to the eastern plant.

Likewise the New York office advances funds regularly to several other yards or branch offices in order to take care of payrolls and freight bills which must be handled promptly. When opportunity arises to purchase a large quantity of material by any one of the other branches it is important to transfer funds from one depository to another. As this is done almost daily, it is necessary that the records be so constructed that one account cannot be overdrawn while another is amply provided with funds.

Operating Statement

The part of the business that I have discussed refers only to the purchase and sale of merchandise and to settlements, the expenses incident thereto being about the same as in other businesses.

All expense items of the same nature are collected from the various yard and branch office cashbooks and posted to the general ledger, with the general ledger items taken from all other records.

As the general office records control, all general accounts such as interest, depreciation of the various plant and equipment accounts and the like are, of course, shown only on the general books. All sales accounts are carried only on the general books and after

offsetting the purchases against the total for the period and applying inventories and expense items, the operating statement is constructed in the usual manner.

We must consider, however, the joint account transactions which may have been only partly executed at the time of closing the books. It is problematical how much gain or loss will result in the disposition of material on hand and what will be the cost of finishing the dismantling of a large plant or tearing up a railroad. The purchase price and cost of obtaining the material, as to labor and freight charges and all other expense items, are charged to the joint account in the general ledger, while all sales and any other credit items are credited to the same account. Should the material purchased on joint account be partly disposed of at the time of closing the books, there is a certain amount of profit that should be credited to the final profit and loss account of the company, but this may be turned into a large loss on disposing of the balance of the material in the next period; hence it is quite difficult to state the amount as it should be shown before the transaction is finally consummated.

Balance-sheet

After the books are closed, the balance-sheet is prepared as is customary in any other business or industry.

However, I should like to call attention to one important account found on the balance-sheet, which, in my opinion, is quite difficult to state correctly. I refer to the inventory of material on hand at time of closing the books.

By referring to the method outlined previously as to purchases and sales of material, it can be seen that a great many cars are in transit on which the freight charges may or may not have been paid; a large number may be rejected and may be either in the company's yards or in transit, and there may be a large miscellaneous tonnage of mixed materials scattered over the company's various yards, as well as partly dismantled plants and steam or electric railways, which the company took over outright and for which it paid either in whole or in part.

At this time, the car record becomes valuable, as the unsold items should in a measure verify the yard stock record books and the traffic department's record of cars in transit.

The remaining items usually shown on the balance-sheet have not been considered as I have attempted only to point out the accounting necessities peculiar to this particular business.

The Journal of Accountancy

Published monthly for the American Institute of Accountants by
THE RONALD PRESS COMPANY, 20 Vesey Street, New York, N. Y.
Thomas Conyngton, president; L. G. Henderson, secretary;
Hugh R. Conyngton, treasurer

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EDITORIAL

Cobbler and Last

Probably there is no proverb more familiar to English-speaking people the world over than "Let the cobbler stick to his last." There are variants of this old saying in nearly every known tongue—and yet despite its almost universal acceptance there is no principle more generally ignored in every-day affairs. People simply will not restrict themselves to their legitimate fields of endeavor, if there is any chance to get over the fence and gambol in the gardens of their neighbors.

All this truism is by way of introduction to a subject which seems to be agitating some of our readers. Frankly we are not greatly perturbed, but the number of complaints and bitter comments received indicates that a few of our friends fear a goblin in the cellar.

The matter is the apparent intention of some banks and trust companies to drive the public accountant out of practice by establishing departments of "audit" or "accounting" or "industrial survey" or "efficiency" or what not. Such departments are organized, if we may believe all that their sponsors assert in public advertisement, primarily with the object of providing the public a means of ascertaining financial condition and prospects. The basic idea is altruistic—and therein lies a difference between the bank and the real accountant—we don't know of any accountant who is in the profession for purely philanthropic reasons. Certainly we know of many who are in accountancy because of their love of the work, but all of them expect to derive a profit—and, what is more to the point, they do.

Your bank or trust company on the other hand is more idealistic.

Every American has heard of idealism and can appraise it duly. The trust company has the interest of its patrons at heart—and in using the word "interest" there is no double meaning.

If merchant Black comes to banker White and seeks to establish credit relations, White may say, and in point of fact often has said: "The statement of condition which you show me may be good or bad. I don't know which it is. If you wish me to give you the credit to which your actual condition should entitle you it will be necessary for you to employ our audit department to make an investigation for you. The fees are not high. The service is better than any other accounting agency can supply. And finally if our audit department be not employed by you it will be useless for you to seek credit with us any way."

There is the same kind of genial altruism in all this as that which animates a great corporation when it says to the village shopkeeper, "You must carry our goods exclusively or we'll open a shop next door and drive you out of business."

The public does not think very kindly of the methods mentioned in the case of the corporation and the shopkeeper; and it will not think any more kindly of the attempt of the banker to hold up the merchant.

As a general rule the public likes to see the cobbler sticking to his last, even if the individual entity which goes to make up what we call the public is apt to wander away from his proper sphere of activity. And when, by reason of what seems something like undue influence, the cobbler thrusts himself into things not of his guild or craft, the public is like to have none of it.

Indeed, experience has shown that in this particular matter of the attempts of bankers to be accountants no great success has ever been achieved. For many years there have been audit departments in some of the trust companies in Detroit and possibly elsewhere. But the accountants of Detroit have thriven nevertheless. There has not been such a rush to employ the trust company as an auditor as to exclude the real professional practitioner.

Quite lately the whole question has attracted renewed interest because the offense has spread further east. Yet, as we said at the outset, there is no great cause for fear. An accountant or two will probably manage to eke out a precarious livelihood in spite of all.

Of course, there are many cogent reasons why the banker should stick to his bank. It seems scarcely necessary to rehearse

them to the readers of this magazine, but here are some which may serve as reminders or as indicators of others:

The American Institute of Accountants has gone formally on record as opposed to the corporate form of professional practice. Audit companies are not in favor with the national body, because they are impersonal and may be commercial instead of personal and professional, as should be the case.

Banks, especially of the trust company species, have long been the butt of adverse criticism because of their diverse ventures. Adding one more department does not make for the strengthening of public confidence.

Bank employees engaged in the audit departments are the servants of the bank—not of the bank's patrons. And among the eternal verities is "No man can serve two masters."

It is one of the solemn and sacred properties of the professional relationship of man and man that there shall be inviolable secrecy in all that arises because of such relationship. The Hippocratic oath is not more binding in effect than the word of honor of the truly professional advisor in accounting, law or any of the other learned callings. Does it require reiteration to convince the business man that a corporation has no soul, and without a soul the relations of man to man degenerate? (Of course, we speak here only of the corporation as a participant in things professional, not as active in its proper field.)

It is conceivable that there might be some day a bank less deeply philanthropic and ideal than those we now have in mind. If we concede so much, it needs only a step to bring us to the conclusion that tremendous possibilities for evil lie in the whole scheme of dragging accountancy down to a commodity purchasable across a counter. As a hint, bear in mind that the directors of a bank have right of access to all the records of the bank. We stoutly affirm that no director of any bank now engaged in the auditing business (for it is then a business, nothing more) would be guilty of even glancing at the auditor's confidential records of a trade rival. But some day a less scrupulous director may be in office and when that day comes—farewell to all that's confidential and honorable.

These are some of the reasons why the idea of audits conducted by a corporation department are repugnant to all that's worthy in professional practice. There are others equally good.

The great point, however, is the desirability of avoiding everything which savors of meddlesomeness. Banking is an honorable calling, in general honorably conducted, but before spreading out to things unrelated to its original purpose, there should be careful consideration.

The accountant and the banker may form a powerful alliance for better business and the brighter day, but let each recognize his own natural limitations.

As we said at the beginning of these notes the matter does not seem to us one of great moment. The public in the long run generally distinguishes between good and evil.

There may be a goblin in the cellar, but he must be a feeble little fellow. We haven't heard him even tapping at the foundations. What we have written is intended to hearten the few timorous ones who think they have felt the house rocking.

Income-tax Department

EDITED BY STEPHEN G. RUSK

During October, at least up to date, one treasury decision has been made. It is No. 3071, and relates to the making of separate income-tax returns by husband and wife domiciled in the state of Texas.

While the subject matter of this decision must of necessity be chiefly a matter of importance to the accounting brethren of that state, it holds some interest for all.

Texas by statute has definitely classified the separate property and the income therefrom of husband and wife and that property and income which belongs to them jointly. Attorney-general Palmer sets forth in treasury decision 3071 how income from these two classes shall be returned for federal tax purposes:

Briefly stated, income from the separate property of husband and wife, except the increase, revenues and rental from lands, is community income, and as such husband and wife may each return half as gross income.

Earnings of husband and wife, or of either of them, are community income, and may also be divided half and half.

The income from property acquired by either as separate property after their marriage is also community income and may be reported as is other community income.

It will be noted that the ruling uses the word "may," and therefore the husband and wife may use their own discretion as to whether or not the return of community income shall be on basis of one-half for each.

Office decision No. 610, explained and amplified by assistant reviewers' memorandum No. 82, is given below. The decision of the department in this case is not supported very well by the argumentative matter, as shown by the conclusions derived from the supposititious example cited.

In the supposititious case a corporation was in possession of a surplus of say $100,000.00 March 1, 1913. During the period ended December 31, 1919, it sustained a net loss of $5,000.00, thereby reducing its surplus to $95,000.00. It declared a dividend of $25,000.00 some time in 1920, during which year and up to date of which declaration its earnings are supposed to have been $15,000.00. Hence, under the most limited interpretation the corporation must have paid its dividend out of the $15,000.00 earned in 1920 and $10,000.00 out of its surplus earnings of March 1, 1913.

The department has ruled that because the corporation earned, say, $5,000.00 in 1919 and $15,000.00 in 1920, only $5,000.00 of the $25,000.00 dividend could be considered to have been paid out of the surplus of March 1, 1913. Truly a remarkable decision reached by a unique method of reasoning.

Among the other opinions given out during the month is legal opinion

1035 (rev.), relating to shrinkage in value of securities and stocks. This opinion is so logical and the argumentative matter proceeds so surely to the correct conclusion, that it offers a marked contrast to office decision No. 610, heretofore mentioned.

That a deductible loss has not been sustained because of the shrinkage of value of stocks and securities owned, when actual disposition by sale or otherwise has not taken place, is a most obvious fact. In the case described in legal opinion No. 1035 (rev.), a corporation is stated to have sought to deduct a loss of this nature when the substantial ownership of the stock and securities had not changed, a subterfuge having been employed by the formation of a new corporation having the same proportionate ownership as the old corporation and by the transfer to this new corporation of the said stock at a loss to the old corporation.

The above-mentioned decisions and opinions, together with a number of others whose subject matter is of especial interest, are given below.

(T. D. 3071, September 18, 1920)

Income tax

Husband and wife—Community property—Opinion of attorney general

1. The earnings of husband and wife domiciled in Texas are community income, and such husband and wife, in rendering separate income tax returns, may each report as gross income one-half the total earnings of the husband and wife.

2. The income from separate property, except the increase, rents and revenues from lands, is community income, and therefore husband and wife domiciled in Texas, in rendering separate income tax returns, may each report as gross income one-half the total income from separate property, except the increase, rents and revenues from land held separately.

3. The income from community property as defined in article 4622, Vernon's *Sayles's Statutes,* is community income, and therefore husband and wife domiciled in Texas, in rendering separate income tax returns, may each report as gross income one-half the total income from such community property.

There is given below in full for your information and guidance an opinion rendered by the attorney general under date of August 24, 1920, dealing with the right of husband and wife domiciled in certain states having so-called "community property" laws to divide certain of their income for the purpose of the income tax.

Department of Justice

Washington, August 24, 1920.

Dear Mr. Secretary: Further acknowledging receipt of your favor of August 12, requesting my opinion on the three questions of law set forth below, to wit:

1. Are the earnings of husband and wife domiciled in Texas community income, and may they therefore in rendering separate income-tax returns each report as gross income one-half of the total earnings of the husband and wife?

2. Is the income from separate property, as defined in article 4621, Vernon's *Sayles's Statutes,* 1918 edition, community income, and may therefore husband and wife domiciled in Texas, in rendering separate income-tax

returns, each report as gross income one-half of the total income from all separate property owned by them?

3. Is the income from community property, as defined in article 4622, Vernon's *Sayles's Statutes,* 1914 edition, community income, and may therefore husband and wife domiciled in Texas, in rendering separate income-tax returns, each report as gross income one-half of the total income from community property?

I have the honor to advise you as follows:

The revenue act of 1918 levies a tax on the net income of every individual (secs. 210 and 211). Net income is defined as gross income less deductions allowed (see 212). Gross income is defined as follows (sec. 213):

That for the purposes of this title (except as otherwise provided in sec. 233) the term "gross income"—

(*a*) Includes gains, profits and income derived from salaries, wages, compensation for personal service (including in the case of the president of the United States, the judges of the supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits, and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (*b*) of section 212, any such amounts are to be properly accounted for as of a different period.

The state constitution of Texas provides:

Art. VII, sec. 19, constitution 1845: All property, both real and personal, of the wife, owned or claimed by her before marriage, and that acquired afterwards by gift, devise, or descent, shall be her separate property; and laws shall be passed more clearly defining the rights of the wife in relation as well as to her separate property as that held with her husband. Laws shall also be passed providing for the registration of the wife's separate property.

The statutes of the state of Texas determining property rights of husband and wife are as follows (art. 4622, Vernon's *Sayles's Statutes,* 1914 edition):

All property acquired by either the husband or wife during marriage, except that which is the separate property of either one or the other, shall be deemed the common property of the husband and wife, and during coverture may be disposed of by the husband only, provided, however, the personal earnings of the wife, the rents from the wife's real estate, the interest on bonds and notes belonging to her, and dividends on stocks owned by her shall be under the control, management and disposition of the wife alone, subject to the provisions of article 4621, as hereinabove written; and further provided that any funds on deposit in any bank or banking institution, whether in the name of the husband or the wife, shall be presumed to be the separate property of the party in whose name they stand, regardless of who made the deposit, and unless said bank or banking institution is notified to the contrary, it shall be governed accordingly in honoring checks and orders against such account.

Article 4621, Vernon's *Sayles's Statutes,* 1918 edition:

All property, both real and personal, of the husband owned or claimed by

him before marriage, and that acquired afterwards by gift, devise or descent, as also the increase of all lands thus acquired, and the rents and revenues derived therefrom, shall be his separate property. The separate property of the husband shall not be subject to the debts contracted by the wife, either before or after marriage, except for necessaries furnished herself and children after her marriage with them. All property of the wife, both real and personal, owned or claimed by her before marriage, and that acquired afterwards by gift, devise, or descent, as also the increase of all lands thus acquired, and the rents and revenues derived therefrom, shall be the separate property of the wife. During marriage the husband shall have the sole management, control and disposition of his separate property, both real and personal, and the wife shall have the sole management, control and disposition of her separate property, both real and personal; provided, however, the joinder of the husband in the manner now provided by law for conveyance of the separate real estate of the wife shall be necessary to an encumbrance or conveyance by the wife of her lands, and the joint signature of the husband and wife shall be necessary to a transfer of stocks and bonds belonging to her, or of which she may be given control by this act; provided also, that if the husband shall have permanently abandoned his wife, be insane, or shall refuse to join in such encumbrance, conveyance or transfer of such property, the wife may apply to the district court of the county of her residence, and it shall be the duty of the court, in term time or vacation, upon satisfactory proof that such encumbrance, conveyance or transfer would be advantageous to the interest of the wife, to make an order granting permission to make such encumbrance, conveyance or transfer without the joinder of her husband, in which event she may encumber, convey or transfer said property without such joinder. Neither the separate property of the wife, nor the rents from the wife's separate real estate, nor the interest on bonds and notes belonging to her, nor dividends on stocks owned by her, nor her personal earnings, shall be subject to the payment of debts contracted by the husband. The homestead, whether the separate property of the husband or wife, or the community property of both, shall not be disposed of except by the joint conveyance of both the husband and the wife, except where the husband has permanently abandoned the wife, or is insane, in which instance the wife may sell and make title to any such homestead, if her separate property, in the manner herein provided for conveying or making title to her other separate estate.

The community property of the husband and wife shall not be liable for debts or damages resulting from contracts of the wife, except for necessaries furnished herself and children, unless the husband joins in the execution of the contract. Provided that her rights with reference to the community property on permanent abandonment by the husband shall not be affected by the preceding sentence.

Article 2469, Vernon's *Sayles's Statutes:*

Upon the dissolution of the marriage relation by death all property belonging to the community estate of the husband and wife shall go to the survivor, if there be no child or children of the deceased or their descendants; but if there be a child or children of the deceased, or descendant of such child or children, then the survivor shall be entitled to one-half of said property, and the other half shall pass to such child or children, or their descendants. But such descendants shall inherit only such portion of said property as the parent through whom they inherit would be entitled to if alive.

The community property system prevails in Texas, Arizona, California, Washington, Louisiana and New Mexico. It seems to have had its origin in France and Spain, and to have been brought thence into our judicial system.

Community property laws provide generally that all property acquired

during marriage, by the industry and labor of either husband or wife or both, together with the produce and increase thereof, belongs to both in equal shares, during the continuance of the marital relation. It has its foundation in the fact or the legal presumption that all property acquired during marriage, otherwise than by gift, devise, or descent, is acquired by the joint efforts of husband and wife (*Nickerson v. Nickerson,* 65 Tex., 281, 284). Their relation partakes of the nature of a partnership, in which each partner may have separate estates or property, as well as common stock of acquisitions and gains. The business of the firm generally is transacted in the name of the husband, and he prosecutes and defends its suits with the same effect as if his partner were named in the case (*Simpson v. Brotherton,* 62 Tex., 170), and although community property has not all the incidents of partnership property it has many of them, and is commonly spoken of as partnership property (*De Blanc v. Lynch & Co.,* 23 Tex., 25; *Wilkinson v. Wilkinson,* 20 Tex., 237). In the conventional partnerships the gains of the partners are in proportion to their respective shares of stock and services, but in the conjugal partnerships the division is equal, though one may have brought in the greater part, if not all of the property from which the profits are derived, or may have contributed all his skill and services unaided by the other (*Wheat v. Owens,* 15 Tex., 241; *Routh v. Routh,* 57 Tex., 589, 595). The fact that one or the other of the spouses may do all the work does not change the character of community property (*Yates v. Houston,* 3 Tex., 452, 454), and though the management and disposal of community property during marriage are usually given to the husband, this is said to be for reasons of public policy and social economy, and not on the grounds that the husband has any greater interest in it than the wife. Section 4622, Vernon's *Sayles's Statutes,* as amended in 1913, and as set forth above, provides that the personal earnings of the wife, the rents from her estate, the interest on bonds and notes belonging to her, and dividends owned on stocks owned by her shall be under the control, management and disposition of the wife alone; but the supreme court of Texas held in *Tannehill v. Tannehill* (171 S. W., 1050) that such amendment did not change the character of rents from the wife's separate property, so as to make them her separate property, but that they continued to belong to the community estate and the husband was owner of one-half of same. (This before the amendment of sec. 4621 in 1917 made the rents from separate lands the separate property of the owner of the land.)

In *Tucker v. Carr* (39 Tex., 98, 102) the court said: "It is well settled that all property acquired during the marriage, whether by the labor of the husband or the wife, or the joint labor of both, whether the title be made to the husband or to the wife or to both jointly, is community property." Also see *Cooke v. Bremond* (27 Tex., 457).

In *Holyoke v. Jackson* (3 Pac., 841) the supreme court of Washington, in defining community property rights in that state, held that the community "is like a partnership, in that some property coming from or through one or other or both of the individuals, forms for both a common stock which bears the losses and receives the profits of its management and which is liable for individual debts; but it is unlike in that there is no regard paid to proportionate contribution, service, or business fidelity; that each individual once in it is incapable of disposing of his or her interest, and that both are powerless to escape from the relationship, to vary its terms, or to distribute its assets or its profits. * * * In it the proprietary interest of husband and wife are equal, and those interests do not seem to be united merely, but unified."

There are numerous decisions holding that the proportional interests of husband and wife in community property are equal regardless of their individual contributions.

In *Merrill v. Moore* (104 S. W., 514) the court said: "This community

of interest is not made to depend upon the acquisition of the property during the time the parties actually live together, nor upon the fact that there was an equal amount of labor or capital contributed by the husband and wife in its accumulation. It is the property acquired during the marriage (with exceptions stated) that 'shall be deemed the common property of husband and wife, and the right to an equality of enjoyment and division thereof, regardless of whether the one or the other has contributed little or nothing to its acquisition' is well recognized." Also see *Edwards v. Brown* (68 Tex., 329); *Saunders v. Isbell* (24 S. W., 307); *Barr v. Simpson* (117 S. W., 1041); *Wright v. Hays admr.* (10 Tex., 130); *Zimpelman v. Robb* (53 Tex., 274). That one-half of the common estate belongs to each spouse is recognized in T. D. 2450, which determines the method of assessing estate tax upon the estate of a decedent spouse.

The decisions in the various states seem to be unanimous on the proposition that the earnings of both husband and wife during the marriage belong to the community.

In *Fennell v. Drinkhouse* (131 Calif., 447), it was held that money earned by the wife while living with her husband was community property, the court saying: "The possession of community property by the wife is the possession of the husband," and in *Martin v. Southern Pacific Co.* (130 Calif., 285), holding that moneys received as damages for injury to the wife are community property, it was said.

The services of the wife are a part of the earning power of the community, and the earnings received for her services constitute community property as much as do the earnings received for the services of the husband. If the injury had been received by the husband, it would not be contended that he could not recover for the damage sustained by the loss of his earning capacity. In either case the earnings would be community property, and any act by which either husband or wife is deprived of the capacity to render services diminishes the capacity to accumulate community property. If the services voluntarily rendered by the wife obviate the necessity of employing other assistance the amount of the community property is thereby enhanced in the amount that would be required for such assistance. * * *

See also *Washburn v. Washburn* (9 Calif., 475).

Under the Louisiana statutes the profits of the industry of both spouses and the fruits of their separate estates fall into the community. *Succession of Webre* (49 La., 149; 22 So., 390); *Knight v. Kaufman* (105 La., 35; 29 So., 711); *Manning v. Burke* (107 La., 456; 31 So., 862). The decisions of the supreme court of the state of Washington are to the same effect. *Abbott v. Weatherby* (6 Wash., 507; 33 Pac., 1070); *Yake v. Pugh* (13 Wash., 78; 42 Pac., 528); *Sherlock v. Denny* (28 Wash., 170; 68 Pac., 452). There are numerous decisions by the supreme court of Texas holding that in Texas the earnings of the husband and wife are community property. *Cline v. Hackbarth* (27 Tex., Civ. App., 391; 65 S. W., 1086); *Johnson v. Burford* (39 Tex., 242); *Pearce v. Jackson* (61 Tex., 642); *Cooke v. Bremond* (27 Tex., 457). In the latter case the court said:

Our whole system of marital rights is based upon the fact that acquisitions either of the joint or separate labor or industry of the husband or wife become common property; and as a general rule, deducible from this principle, all property acquired by purchase or apparent onerous title, whether the conveyance be in the name of the husband or of the wife, or in the names of both, is prima facie presumed to belong to the community.

Under the laws of the various states wherein the community property system obtains, the earnings of separate property of the spouses with such exceptions as are specifically provided for by statute, are community property. See *Barr v. Simpson* (117 S. W., 1040, Tex.) and *Hayden v. McMillan* (23 S. W., 430, Tex.).

The latter case was decided when article 2851, revised statutes of Texas,

provided that all the property owned by the wife before marriage or acquired afterwards by gift, devise, or descent, and the "increase of all lands thus acquired" should be the separate property of the wife. And the court held that rents accruing on the separate lands of the wife were community property and subject to garnishment for community debts. This case also establishes the proposition that such community interest attaches the moment the property comes into existence, the court saying: "The moment the rents become due they are disconnected from the land and become personal property, and, being acquired by the joint labors of the married couple put forth during the marital relation, they must necessarily be community."

From the above authorities I am convinced that under the law of Texas the earnings of the husband and wife belong to them jointly in equal shares; that the community interest attaches as soon as the right to the wages comes into existence; and that the increase and revenues from the separate property of each spouse except the increase, rents and revenues from lands, is also community property in which the interests of husband and wife are equal.

These propositions being established it follows that the earnings of husband and wife and the revenues from their separate personal property are community "income," under the provisions of the act of February 24, 1919. Gross income under the terms of the act includes "gains, profits and income derived from salaries, wages, compensation for personal services of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property."

The law of Texas presumes that the earnings of the husband and wife are the product of their joint labor and rests the ownership of same in the community; they are therefore community "income," to wit, "gains, profits and income" of the community, "derived from salaries, wages, compensation for personal services," * * * professions, vocations, as the case may be.

Under the statutes of Texas heretofore set forth, the separate property of the spouses is defined as that "owned or claimed by him (or her) before marriage, and that acquired afterwards by gift, devise or descent," and also "the increase of all lands thus acquired, and the rents and revenues derived therefrom." It is to be noted that the increase of separate personal property and the revenues derived therefrom are not the separate property of the owner of the personalty, but are community property. *Carr v. Tucker* (42 Tex., 330); *Epperson v. Jones* (65 Tex., 425); *Barr v. Simpson* (117 S. W., 1041). They are therefore "income" to the community, to wit, "gains, profits and income * * * from businesses, commerce, or sales or dealings in property * * * growing out of the ownership or use of or interest in such property."

Since one-half of all community property vests in each spouse, it follows that one-half of the increase and revenues from separate property of the spouses, except increase and rents and revenues from lands, is income to each of said spouses.

Community property under the laws of Texas belongs jointly to husband and wife; it follows that the income therefrom accrues to husband and wife in equal shares. I therefore conclude:

1. That the earnings of husband and wife domiciled in Texas are community income, and such husband and wife in rendering separate income-tax returns may each report as gross income one-half the total earnings of the husband and wife.

2. That the income from separate property, except the increase, rents and revenues from lands, is community income, and that therefore husband and wife domiciled in Texas in rendering separate income-tax returns may each report as gross income one-half the total income from separate property, except the increase, rents and revenues from land held separately.

3. That the income from community property as defined in article 4622,

Vernon's *Sayles's Statutes,* quoted above, is community income, and that therefore husband and wife domiciled in Texas in rendering separate income-tax returns may each report as gross income one-half the total income from such community property.

Respectfully,
A. MITCHELL PALMER,
Attorney General

Hon. DAVID F. HOUSTON,
Secretary of the Treasury.

Office Decision No. 610

Section 201, article 1541: dividends

The M company operated at a profit during the years 1913, 1917 and 1919, but sustained losses during the years 1914, 1915, 1916 and 1918, so that for the entire period of 1913 to 1919, inclusive, its books showed a net operating deficit.

Having on hand a large surplus, accumulated prior to 1913, the company declared a dividend in 1920, payable out of such surplus, and it is contended that this dividend is exempt from tax, since the books of the company show a net operating deficit for the period subsequent to 1913, and notwithstanding the fact that a profit was realized during each of the years 1913, 1917 and 1919.

While not specifically so stated it is assumed that the dividend was paid in cash. In accordance with paragraph (b) of section 201 of the revenue act of 1918, it will, therefore, be deemed to have been paid out of earnings accumulated since February 28, 1913, in so far as such earnings were sufficient for its payment. The distribution will not be subject to tax in the hands of the stockholders to the extent that it was made from earnings or profits accumulated prior to March 1, 1913. The operating losses of the company sustained in 1914, 1915, 1916 and 1918 are not to be charged against the earnings or profits of any particular year, and the fact that there were such losses does not prevent or alter the application of the rule that the dividend will be deemed to have been paid from earnings accumulated since February 28, 1913, as provided in section 201 of the act. Accordingly the dividend is taxable to the recipient stockholders at the rates applicable for 1920, the year in which paid, to the extent that it represents a distribution of the current undivided earnings accumulated since February 28, 1913.

Assistant Reviewer's Memo. No. 82

Section 201, article 1541: dividends

The committee is in receipt of a request for advice as to the correctness of the ruling published as office decision 610, bulletin 31-20-1098, relative to the taxability of the earnings of a corporation which in some years subsequent to 1913 has had large losses and in another year large profits.

In the judgment of the committee and upon the facts in the instant case on which office decision 610 was based the correctness of the ruling depends upon the meaning to be attached to the words "accumulated since February 28, 1913." The word "accumulated" as used in this sense means, in the judgment of the committee, profits which have been earned and not dissipated by *subsequent* losses. While it is recognized that assets cannot be earmarked as representing earnings of any particular year, it is a fair assumption that the earliest surplus of a corporation is likely to be represented in its balance sheet by fixed assets, while the later earnings are more apt to be represented by liquid assets. Consequently, any losses sustained in a given year will be met out of the most recent earnings embraced in its surplus. It follows that profits of any year cannot be diminished by prior losses, but it is fair to assume that such earnings, to the extent necessary, will go to satisfy subsequent losses.

To illustrate what is meant, let us take a supposititious case: A cor-

poration had on March 1, 1913, a surplus of $100,000; during the remainder of 1913 it earned $10,000; from January 1, 1914, to December 31, 1916, it lost $25,000; during 1917 it earned $15,000; during 1918 it lost $10,000; during 1919 it earned $5,000, and in 1920 declared a dividend of $25,000, its earnings for the current year up to the date of the dividend being $15,000. Tabulated with the fluctuations of surplus involved, this would show as follows:

Earnings.		Losses.		Surplus.	
				Mar. 1/13..	$100,000
Mar. 1 to Dec. 31/13..	$10,000			Dec. 31/13.	110,000
		Jan. 1/14 to Dec. 31/16.	$25,000	Dec. 31/16.	85,000
Jan. 1 to Dec. 31/17..	15,000			Dec. 31/17.	100,000
		Jan. 1 to Dec. 31/18..	10,000	Dec. 31/18.	90,000
Jan. 1 to Dec. 31/19..	5,000			Dec. 31/19.	95,000
Jan. 1/20 to date of dividend	15,000				
		Dividend, 1920	$25,000		

The most recent loss shown is that of 1918. This, of course, was met out of earlier earnings, and the corporation must have on hand at the present time the $5,000 earned in 1919 as well as the $15,000 earned in the current year. Of the $15,000 earned in 1917, $10,000 was lost in 1918, leaving it with $5,000 earnings of 1917 still on hand. The $15,000 of 1920 earnings, together with the $5,000 of 1919 earnings and the $5,000 remaining of 1917 earnings covers the dividend of $25,000, showing that all of the dividend was paid out of earnings accumulated since March 1, 1913, notwithstanding the fact that the company's surplus on December 31, 1919, was $5,000 less than it was on March 1, 1913. From this it might be argued that necessarily, since its surplus on December 31, 1919, was less than that of March 1, 1913, any distribution in excess of the earnings of 1920 must have come out of the March 1 surplus. This, however, is a fallacy, since there is no obligation to recognize for tax purposes the surplus of March 1, 1913, as capital which must be made good before there can be any distribution of profits.

Upon the figures given in the letter, which was the basis of office decision 610, the only profits earned since February 28, 1913, which had not been dissipated by subsequent losses, were the amounts earned in 1919 plus any earnings of 1920 up to the date of the dividend. These amounts are the only amounts which if distributed would be subject to tax.

Assistant Reviewer's Report No. 269

Section 214(a) 4, 5, 6, article 141: losses. (Also section 214(a) 1, article 111)

A loss incurred by a corporation through the embezzlement of securities held in bailment by it is an allowable deduction from gross income of the year in which demand was made by the bailors for the return of the securities and the replacement made by the company.

The committee has had under consideration the appeal of the M company from a ruling of the income-tax unit disallowing a deduction from gross income for the year 1917, on account of loss accruing out of an embezzlement occuring over a period of years from 1908 to 1916.

In view of the circumstances of this case the committee was in doubt as to whether law opinion 845 (ruling 6-19-279; p. 118, cumulative bulletin, December, 1919), is applicable, and requested the opinion of the solicitor upon the various legal questions involved. It is now in receipt of a memorandum from him as follows:

Opinion has been requested as to the deductibility of amounts paid out in 1917 to cover the embezzlement in prior years of securities held by a company in bailment.

Section 12(a) of the revenue act of 1916, as amended by the revenue act of 1917, provides:

In the case of a corporation, joint stock company or association, or insurance company organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources. * * *

First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties. * * *

Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise. It appears that the company held certain securities owned by four of its clients for the purpose of collecting income and remitting the same from time to time to the owners of the securities, such securities to be returned to the owners upon demand. During the years from 1908 to 1916, inclusive, an officer of the company, by means of forged receipts, appropriated these securities to his own use. This misappropriation of the securities was not discovered until 1917, whereupon the company, at the demand of the clients for delivery of their securities, replaced the securities at a total of $8x$ dollars. The company claims a deduction, in computing the net income for 1917, to the amount of $6x$ dollars, representing the difference between the cost of the replaced securities and the claims against insurance companies and unliquidated assets of the embezzler.

By law opinion 845 it was held that a loss incurred by a corporation through the embezzlement of its funds is an allowable deduction from gross income for the year in which the embezzlement occurred, on the ground that the loss is sustained when the embezzlement occurs, and that the time of the discovery of the loss bears no relation to the date it was sustained. In the instant case, however, the embezzled securities were not the property of the corporation, but were held by it in bailment, to be returned to the owners upon demand. At the time of the embezzlement the amount of the loss to the company could not be determined, for it was controlled by the replacement cost of the securities at the date of demand by the owners. The claims against the company might have been waived by the clients, and in that case the company would have sustained no loss. Furthermore, the liability of the company to the clients on account of the loss of the property held in bailment was not certain and might have been contested, the company contending that in a bailment for mutual benefit it is held to the exercise of ordinary care in relation to the subject matter thereof and is responsible only for ordinary negligence. *New York Cent. R. Co. v. Lockwood,* 17 Wall. 357; *Bleakley v. New York,* 39 Fed. 807; *Fairmount Coal Co. v. Jones, etc., Co.,* 134 Fed. 711; *Smith v. British Steamship Co.,* 123 Fed. 76.

The amount expended by the M company was in fact a payment in settlement of a legal liability. The right of action of the clients accrued when the demand was made for the return of the securities. and the liability of the company was incurred on that date. *Stevens v. Stevens,* 132 Mo. A. 624; *Walker v. Bement,* 94 N. E. 339; *Woods v. Latta,* 3 Mont. 9; *Brown v. Cook,* 9 John 361. In *Walker v. Bement,* supra, the court, speaking of the liability of a bailee, said:

A loan of corporate stock to be returned on demand only obligates the borrower to return it on demand, and the right of the lender to money for the stock does not arise until failure to return on demand, and the right to the money arises out of the breach of the obligation to return on demand.

In view of this opinion, in which the committee concurs, it is held that the loss incurred by the M company through the embezzlement of securities held in bailment by the company is an allowable deduction from gross income in 1917, the year in which demand was made by the bailors for the return of the securities, and the replacement made by the company.

Legal Opinion No. 1035 (Rev.)

Section 214(a) 4, 5, 6, article 144: shrinkage in securities and stocks. (Also section 233, article 542.) (Also section 234, article 564)

Income tax—Act of October 3, 1913, section G(b). Revenue act of 1916, section 12(a) second, section 12(a) third

(1) Where a new corporation is organized having the same stockholders with the same stockholdings as the old corporation, to which the old corporation transfers a large amount of stocks and bonds at a loss, less than 1% of the purchase price being paid in cash and the balance being paid for notes secured by the stocks and bonds sold, possession of which was retained by the old corporation with power of sale in case of default, the new corporation having no other assets, the whole transaction will be regarded as a sham and a subterfuge to evade taxation and the loss will be denied. Article 148, regulations 33, revised; article 144, regulations 45; article 77, regulations 41.

(2) A corporation derives no gain from a sale of its own stock previously purchased by it. Article 542, regulations 45. But interest actually paid in cash or its equivalent by stockholders on sales of stock on credit to them is taxable income to the corporation.

(3) A manufacturer and dealer in merchandise which also deals largely in securities is entitled to deduct in full interest on indebtedness secured by such securities under section G(b) of act of October 3, 1913. Such taxpayer is not entitled to deduct such interest in full under section 12(a) third of the revenue act of 1916, since it is not "a dealer only" in such securities. Law opinion 621.

On examination of the income and excess profits tax returns of the M company for the years 1912 to 1917, inclusive, several questions have been submitted for ruling. They will be treated separately.

(1) The deduction of a loss of $475x$ dollars on securities sold to N company.

The M company, engaged in an industrial business, owned certain stocks and bonds which it carried as liquid reserves available for opportune purchases of material. Most of these securities were listed on the New York stock exchange. They had cost (or were worth on March 1, 1913) $1,764x$ dollars; and the aggregate market value in November, 1917, was about $475x$ dollars less than this cost.

The stockholders of the M company established a new corporation, hereinafter called the N company, having the same stockholders with the same proportionate stock holdings as the M company. The N company then bought the stocks and bonds above mentioned from the M company at market prices. It paid the M company $12x$ dollars cash received from the sale of its capital stock, and gave for the balance of the purchase price its demand notes bearing 6 per cent interest with these same securities as collateral. It had no other assets.

The apparent effect of this transaction is to entitle the M company to a deduction of $475x$ dollars as a loss and to substitute admissible assets in place of inadmissible assets in the computation of invested capital.

Section 12(a) second, of the revenue act of 1916, permits a corporation to deduct from gross income "all losses actually sustained and charged off within the year and not compensated by insurance or otherwise." Regulations 33, revised, requires that losses must be "evidenced by closed and completed transactions."

Art. 148. *Shrinkage in securities.*—A corporation possessing securities such as stocks and bonds cannot allowably deduct from gross income any amount claimed as a loss on account of the shrinkage in value of such securities through fluctuations of the market or otherwise; the only loss to

be allowed in such cases is that actually suffered when the securities mature or are disposed of.

Substantially the same rule is repeated in article 144 of regulations 45.

In the present transaction the identity of stock ownership of the two corporations has an important bearing on the questions of deductible loss. It is clear that under article 77 of regulations 41 these corporations would be deemed affiliated and required to file a consolidated return for excess profits tax purposes. In such case the intercorporate transactions would be eliminated and no loss could be claimed, and there would be no change in invested capital because of this transaction. But even as to income tax it is clear that because of the identity of ownership of the stock the M company continued to be in practical control of the N company, and therefore in control of the securities themselves, so long as they remained in the hands of the N company. This form of disposition by the M company could have had no other purpose than to postpone the realization of gain or loss on these securities; otherwise the M company would simply have sold them on the stock exchange.

The retention of control, moreover, not only postponed liquidation but preserved the power of the M company to undo the entire transaction and revest itself with the securities without violating anybody's substantial rights or interests. This power was made more effective by the retention of the custody of the securities as collateral to the notes with power to sell in case of default.

Besides retaining the practical control of the securities the M company continued to carry the risk of their depreciation or loss; for although it had the absolute obligation of the N company in the form of the latter's notes, the only assets behind the notes were these securities. The fact that the risk was theoretically lessened by the payment of $12x$ dollars cash is not very material, since that payment, received indirectly from the company's own stockholders, was less than 1% of the value of the securities.

As a result of the transaction, founded upon joint proportional ownership of the stock of both companies, the M company retained substantially, and it was the whole purpose of the plan that it should retain any advantage from a rise in value of these securities; and for the same reason it retained the risk of loss. It is, therefore, clear that disregarding form and looking at substance the realization of this loss has been postponed, and the transaction is not a closed and completed one. The whole procedure is obviously a sham and device to evade taxation.

In such cases the taxing authorities are not bound to recognize the forms adopted by the taxpayer to evade the imposition of taxes where such forms do not reflect an actual change in substance. (*H. M. Louden Sons Lumber Company v. Elmer Township* (Mich., 1900), 81 N. W. 965; *Montgomery v. Marshall County* (Iowa, 1911), 129 N. W. 329; *Sisler v. Foster* (Ohio, 1905), 74 N. E. 639; *Shotwell v. Moore* (1888), 129 U. S. 590). The situation in this case does not indicate a bona fide change in legal relations made by the taxpayer to reduce taxes, but is mere sham and subterfuge which accomplishes no actual or substantial change in conditions and leaves realization of gain or loss for future determination. The loss apparently realized here is a mere bookkeeping transaction and not the result of a bona fide sale or other disposition of the securities in question. The claim of the M company for the deduction of the loss of $475x$ dollars must, therefore, be denied.

(2) The question of profits on the sale of stock to various employees.

The revenue agent included $4x$ dollars in gross income for 1912 and $47x$ dollars in gross income for 1917 on account of profits from the sale of treasury stock previously acquired by the company by purchase and resold to employees at an advanced price. The taxpayer claims that these so-called sales were in fact merely options, and that for that reason it

should not be required to account for any gain. The nature of the agreement, however, becomes immaterial in view of article 542 of regulations 45, promulgated since the revenue agent's report. That article provides in part:

If, for the purpose of enabling a corporation to secure working capital or for any other purpose, the stockholders donate or return to the corporation to be resold by it certain shares of stock of the company previously issued to them, or if the corporation purchased any of its stock and holds it as treasury stock, the sale of such stock will be considered a capital transaction, and the proceeds of such sale will be treated as capital, and will not constitute income to the corporation.

This principle applies with equal force to the revenue act of 1916 as amended and to the corporation tax act of 1909. No amount, therefore should be included in gross income for 1912 or 1917 as profit from the sale of treasury stock.

(3) From further facts submitted by the taxpayer since the rendering of law opinion 1035, it appears that stock was sold by the M company to three of its stockholders at various times as follows:

In 1909 the corporation entered into an agreement with B, one of its employees, with respect to the sale of ten shares of its stock which previously had been issued for cash at par, and had then been donated back to the company by its stockholders for sale or other disposition for its benefit. By this agreement of sale the company agreed to issue to B ten shares of its capital stock for which he agreed to pay in cash in 1914, $50x$ dollars, and 6% per annum thereon from the date of the issuance of the stock to date of such payment, with the proviso, however, that in the event that in 1914 B desired to surrender his rights to the stock he might do so, and thereupon be repaid any amounts paid on account, and be released from any further liability to the company on account of the purchase price. The ten shares of stock were issued as provided in the agreement, and were held by the company as security. In 1914, B having made no payment whatever under the terms of the agreement, entered into a new agreement canceling the old agreement. By the terms of this new agreement B agreed to purchase the ten shares of stock in question and to pay therefor in 1919 the amount of $65x$ dollars. The difference between the original price and the new price, viz.: $15x$ dollars, is, of course, 6% interest on $50x$ dollars for five years.

A similar contract of sale was entered into by C, another stockholder. In this case, however, C having made no payment whatever under his original agreement, the new agreement was not executed until 1915, approximately one year after the maturity of the old agreement. By the terms of the new agreement C, as in the case of B, agreed to pay $65x$ dollars for ten shares of stock which he had previously agreed to purchase for $50x$ dollars.

Upon reconsideration it is held that the corporation received no income in 1914 or 1915 with respect to the above two items of so-called interest. An examination of the original agreements of sale, which are not set forth in detail herein, shows that the obligation on the part of the stockholders was to pay the 6% interest not annually, semi-annually or at any specified time during the life of the contract, but at the expiration thereof, *i. e.*, as part of the purchase price of such stock. There is no indication that the parties intended that the corporation would be able to insist upon payment of the interest at any time prior to the expiration of the time fixed by the agreements. The new agreements in each case canceled and annulled the old one, the corporation specifically relinquishing any claim that it may have had. It must be concluded, therefore, that the corporation did not in 1914 or 1915, at the time the new agreements were made, receive payment of the interest in cash or its equivalent. The new contracts themselves cannot be considered the equivalent of cash, for they provide that if the purchase price

is not paid at the new due dates, the certificates of stock shall be surrendered to the company and canceled, and the company shall repay to the stockholders any amounts which they have paid on account.

In the case of the sale of stock by the corporation to A, another stockholder, the facts were somewhat different. In that case a similar contract of purchase was entered into in 1912, maturing in 1917. But A, instead of entering into a new agreement at the expiration of the old one, exercised his right to purchase the stock by executing and delivering to the company his collateral promissory note for $65x$ dollars, the stipulated purchase price $50x$ dollars, plus 6% interest thereon for five years, amounting to $15x$ dollars. The time of payment of this note does not appear, but so far as the evidence submitted is concerned, there is nothing to show that the note was not good and collectible. In this case the corporation received cash or its equivalent, and the note should be taken at its fair discount value when received by the corporation. So much of that fair discount value as represents the $15x$ dollars interest should have been included in the gross income of the corporation for the year 1917.

(4) The revenue agent disallowed certain deductions of interest for 1913, 1914, 1915 and 1916.

In each of these years the agent permitted the deduction of the full amount of interest deductible according to the terms of the statute then in force, unless a further allowance is permitted under the provisos quoted below. Section G(b) of the act of October 3, 1913, reads in part:

Provided, that in case of indebtedness wholly secured by collateral the subject of sale in ordinary business of such corporation, joint stock company, or association, the total interest secured and paid by such company, corporation, or association within the year on any such indebtedness may be deducted as a part of its expenses of doing business.

Section 12(a) third, of the revenue act of 1916, reads in part:

Provided further, that in the case of indebtedness wholly secured by property collateral, tangible or intangible, the subject of sale or hypothecation in the ordinary business of such corporation, joint stock company, or association as a dealer only in the property constituting such collateral or in loaning the funds thereby procured the total interest paid by such corporation, company, or association within the year on any such indebtedness may be deducted as a part of its expenses of doing business, but interest on such indebtedness shall only be deductible on an amount of such indebtedness not in excess of the actual value of such property collateral.

This company was originally organized to buy, sell and manufacture certain commodities, but in 1909 it greatly enlarged its powers so that it was expressly authorized to purchase, hold and dispose of stocks, bonds and other securities, and to borrow money on notes, bonds or other debentures. The company contends that the items of interest disallowed are paid on indebtedness of the company wholly secured by collateral consisting of miscellaneous stocks and bonds of other corporations, and in part by warehouse receipts for merchandise dealt in by the company. The revenue agent's report supports this statement of the taxpayer. It is said on page 4:

The company uses its stocks and bonds held in other companies as collateral.

The company's returns from 1912 to 1917 disclose that large amounts were received as dividends, and that from year to year such amounts fluctuated greatly, indicating in a general way considerable dealing in stocks. It would appear, therefore, that stocks and bonds are the subject of sale in the ordinary business of the corporation. This is, of course, true of the merchandise which in some cases furnished the security. It, therefore, seems clear that this is indebtedness wholly secured by collateral the subject of sale in the ordinary business of the corporation, and that interest paid

thereon is, therefore, deductible in full under the provisions of the act of October 3, 1913. This settles the question of interest for the years 1913, 1914 and 1915 in taxpayer's favor.

The provisions of the revenue act of 1916, however, are much stricter, and the benefits of this proviso are confined to interest paid on indebtedness wholly secured by collateral the subject of sale or hypothecation in the ordinary business of the corporation as a dealer only in the property constituting the collateral. This company is not only a dealer but a manufacturer, and is not primarily a dealer in securities but only incidentally a dealer in securities and primarily a dealer and manufacturer in certain merchandise. It is not, therefore, entitled to the deduction of interest under this proviso in 1916, except as to interest paid on indebtedness, if any, secured by the hypothecation of merchandise or warehouse receipts therefor. This view is supported by law opinion 621 (revoked on other grounds by law opinion 634).

(NOTE: L. O. 1035 (rev.) supersedes O. 1035, ruling 21-20-954.)

Assistant Reviewer's Report No. 272

Section 214(a) 8, article 168: depreciation of drawing and models

Appeal of the M company, in re disallowance of certain claimed values as of March 1, 1913, of plant and equipment as a basis for subsequent depreciation allowance.

The committee has had under consideration the appeal of the M company, from the action of the income-tax unit in disallowing certain claimed values as of March 1, 1913, of plant and equipment as a basis for subsequent depreciation allowance.

It appears that it had been the practice of this company, which was engaged in the manufacture of machinery, to charge to expense the cost of tracings, patterns and flasks necessary in their business instead of capitalizing such items, and the question arises as to the inclusion of the value of such items on March 1, 1913, in capital accounts for the purpose of determining the proper basis for depreciation subsequent to that date.

The company had an appraisal made in 1912, which appraisal did not include the items above enumerated. Although the letter transmitting the appeal states that the propriety of the acceptance of this appraisal is one of the questions submitted, it is understood that the unit concedes that in the absence of other evidence this appraisal, less depreciation to March 1, 1913, should be accepted as the value on March 1, 1913, of items included therein, in which view the committee concurs. As before stated, this appraisal did not include tracings, drawings, patterns and flasks, and in 1920 the company had an appraisal made as of the date of March 1, 1913, of the value of these items not previously included. It appears that the drawings are dated, and that the only properties included in the second appraisal, as of March 1, 1913, are those tracings and drawings which can be identified by date as being on hand March 1, 1913, and the patterns and flasks made in conformity therewith.

The company states that from 1912 to 1916 it was engaged in repair work which required no new equipment of the character sought to be valued, and that in 1916 production was changed to machinery of a different character, which manufacture continued up to practically the present time; that the manufacture of the former machines has just been resumed, and that consequently it is fairly demonstrated that all of such equipment must have been on hand March 1, 1913. The committee is of the opinion that this is a fair conclusion under the circumstances and should be admitted by the bureau.

The second question is as to the method of determining the value on March 1, 1913, of this equipment. It is manifest that the taxpayers and the

bureau must constantly engage in the valuation of properties owned on March 1, 1913, for the purpose of determining profit or loss on the sale thereof, and it is the consistent rule to fix such values, even though no appraisals were made on or about March 1, 1913, by the best evidence which can be arrived at and upon "any evidence which will reasonably and adequately make it appear." (Article 1561, regulations 45.) The method used by the appraisal company was to ascertain from data in their possession the reproduction cost on March 1, 1913, of the equipment under consideration and to accept that, less depreciation from original acquisition, as the true value of that date. This appears to the committee to be a fair and reasonable method of determining value of equipment and to establish such value as nearly as it is possible now to do. In the absence of any evidence, therefore, showing that the values so established were not fair values as of that date, the committee recommends their acceptance.

There is a question, however, in this connection not raised by the unit to which its attention is invited. To the extent that such items of equipment were charged to expense during the years from 1909 to 1912, inclusive, such charges were erroneous, and the income as reported for purposes of the excise tax act of 1909, was incorrect. The company should, therefore, be required as a condition to acceptance of these values to readjust its returns for those years by the inclusion in income of the cost so ascertained of all articles here authorized to be treated as capital from March 1, 1913.

The committee therefore recommends, in the absence of evidence tending to controvert the values stated, that the appraisals of 1912 and 1920, as of March 1, 1923, be accepted as fixing values of equipment on March 1, 1913, for purposes of subsequent depreciation, and that the returns for 1909 to 1912 be adjusted along the line above indicated.

Association of Certified Public Accountants of West Virginia

At the annual meeting of the Association of Certified Public Accountants of West Virginia, held at Charleston, August 19, 1920, the following officers were elected for the ensuing year: president, S. C. Board; vice-president, David A. Jayne; secretary, William T. Green.

W. B. Castenholz draws attention to an error in the announcement relative to his firm in the October issue of THE JOURNAL OF ACCOUNTANCY. Offices of the firm are in Chicago, New York, Kansas City, Tulsa and Houston.

William Dolge announces that he has admitted to partnership Benjamin H. Hicklin and George E. H. Satchell. The firm name will be William Dolge & Co., 311 California street, San Francisco, California.

H. Braverman and W. I. Smith announce the formation of a partnership, with offices in the Kinney building, Newark, New Jersey, and the Bankers Trust Company building, Norfolk, Virginia.

S. W. Park announces the opening of an office at 3412 Woolworth building, New York.

Students' Department

EDITED BY H. A. FINNEY

DIVISION OF PROFIT ON SALE OF PARTNERSHIP GOODWILL

Considerable space in the October *Students' Department* was devoted to a reply to L. F. Ratterman's contention that profits on the sale of partnership goodwill should be divided in the capital ratio. Space did not permit printing our reply in full in the October issue.

In that issue we tried to show that the profit and loss ratio should apply in accordance with the argument of the partners as to the division of the profits. There remains to consider the matter of fairness.

If partners make equal investments but share profits unequally, which is more equitable: to divide the profit on the sale of the goodwill in the capital ratio or in the profit and loss ratio? Mr. Ratterman contends for the capital ratio, because "that which is received (for the goodwill) is paid by the purchaser because certain extraordinary profits have been earned in the past, but when such profits were earned they were then divided on an unequal basis. To say that because one partner has already received a greater part of the profits, he should receive the greater part of an amount paid by a purchaser in excess of the real value of other assets acquired is altogether unreasonable." And in an earlier letter he wrote: "Brown has received 60% of the goodwill before the sale is made, and to divide the $90,000 received for the goodwill as a profit in effect divides the same thing twice."

Some flaws appear in this argument. In the first place, what about the assertion that the payment for goodwill is made because certain extraordinary profits were made in the past—profits already divided? These extraordinary profits are significant only because they indicate that extraordinary profits will be made in the future. Brown and Smith are not selling past profits already divided; they are selling the right to extraordinarily large future profits. If they had chosen not to sell the business, they would presumably continue to divide these future profits in the ratio of 60% and 40%. Since they have chosen to sell their rights to these future profits the payment they receive should be divided in the ratio in which they shared the rights which they sold.

One customary method of computing the value of goodwill is known as the "year's purchase" plan. Using the profits of the past as a guide, an estimate is made of the annual profits which probably will be made in the future. The goodwill value is then agreed upon by purchaser and seller as a certain fraction or a certain multiple of this estimated annual future profit. The sellers are simply realizing the profit at the time of the sale instead of waiting to realize it year by year. If an unequal division of this profit would be fair

if postponed until a future date, where is the unfairness of immediately dividing it in the same unequal ratio?

In the second place, what about the statement: "Brown has received 60% of the goodwill before the sale is made, and to divide the $90,000 received for the goodwill as a profit in effect divides the same thing twice." It would seem more exact to state that in the past the partners have divided the income produced by the goodwill, and they are now proposing to divide the $90,000 profit realized by the sale of the goodwill.

Take an analogous case. Suppose that Brown and Smith had invested $410,000 in an orchard, dividing the income in the ratio of 60% and 40%. Efficient cultivation, pruning and spraying cause the trees to bear heavily and there is a large annual income to divide. Because of this fact they are able to sell the orchard for $500,000, so that there is a profit of $90,000 to divide. It is difficult to see that dividing the income from the orchard and the profit on the sale of the orchard "in effect divides the same thing twice."

Recognizing this distinction between the annual income from the goodwill and the profit realized by its sale, is it equitable to divide the two items in the same ratio? This may be answered by considering two contrasting business policies. Brown and Smith might have embarked on a policy of questionable advertising which would sell goods but leave customers dissatisfied. For a while there might be large profits to divide but in the end there would be no goodwill. Or they might adopt a policy of conservatism and service at considerable expense in the early years which would eventually create a good reputation and a valuable goodwill. The profit on the sale of the goodwill would be a realization of the gain which might perhaps have been made at the start by the adoption of another policy, and fairness would seem to require its division in the profit and loss ratio.

There is still another reason why the gain on the goodwill should be divided in the profit and loss ratio. Presumably Brown receives 60% of the profit because he contributes more time or ability to the management of the business and the production of profit. Now the value of the goodwill depends upon and is proportionate to the amount of excess profit. If Brown is instrumental in producing 60% of the excess profit it seems logical to assume that his skill and services produced the larger proportion of the goodwill.

The question under consideration is the old one, decided long ago by accountants, as to whether the same ratio should govern the division of profits on operations and so-called profits on realization. The following quotation from Dickinson's *Accounting Practice and Procedure* is of interest:

"In the widest possible view, profits may be stated as the realized increment in value of the whole amount invested in an undertaking. Inasmuch, however, as the ultimate realization of the original investment is from the nature of things deferred for a long period of years during which partial realizations are continually taking place it becomes necessary to fall back on estimates of value at certain definite periods, and to consider as profit or loss the estimated increase or decrease between any two such periods."

All accountants agree that at best a profit and loss statement and a balance-sheet are estimates. The capital accounts shown by a balance-sheet

are the result of closing thereto estimated profits and losses. The true profit or loss which partners agree to divide in a stipulated ratio is not known until what Sir Arthur Dickinson calls "the ultimate realization of the original investment" takes place. The difference between the selling price of a business and the capital accounts of partners before the sale is an adjustment required to bring the estimated profits up or down to the true profits or "realized increment."

In contending that the profit on the sale of goodwill should be divided in the capital ratio, Mr. Ratterman is maintaining that the profit and loss sharing agreement should apply to only the annual, guessed-at profits. The expressed intention of the partners cannot be put into effect that way. Profits disclosed by "the ultimate realization" must be divided in the agreed ratio so as to correct any errors caused by the under-estimate or over-estimate of periodically divided losses and gains. If the estimated profits are divided in the agreed ratio periodically, the profits disclosed at dissolution which rectify the estimates must be divided in the same ratio or the true profits will not be shared as agreed.

To illustrate, assume that A and B, with equal capitals and sharing profits in the ratio of 60% and 40% have during five years of operations set up a reserve for depreciation by annual charges to profit and loss. At the time of selling their business the books show:

Buildings	$150,000.00
Reserve for depreciation.........................	27,000.00
Book value	$123,000.00

The business is sold and the price agreed upon for the buildings is $132,000. Here is an apparent gain of $9,000. Now Mr. Ratterman states that "when partners are selling out they are no longer conducting the business," and it seems fair to assume that he would not consider this $9,000 one of those "usual operating profits" which he thinks partners have in mind when they agree to divide the profits on an unequal basis. Therefore, if he is consistent, he will advocate dividing this $9,000 profit equally.

Should he do so? The "ultimate realization" shows that A and B realized $132,000 for buildings which apparently cost $150,000. The use of the buildings for five years cost the partners $18,000, although they estimated that the cost was $27,000. This annual depreciation charge reduced the estimated profits $27,000 during five years, so that the profits credited to A and B were reduced as follows:

	A (60%)	*B* (40%)	*Total*
Total estimated depreciation.............	$16,200.00	$10,800.00	$27,000.00
True amount disclosed at ultimate realization	10,800.00	7,200.00	18,000.00
Required correction in profit and loss ratio.	$5,400.00	$3,600.00	$9,000.00

Applying Mr. Ratterman's method, the $9,000 would be credited to A and B.

	A	*B*	*Total*
Debits for estimated depreciation........	$16,200.00	$10,800.00	$27,000.00
"Unusual profit" divided equally..........	4,500.00	4,500.00	9,000.00
True expense (improperly divided).......	$11,700.00	$6,300.00	$18,000.00
The depreciation expense should have decreased the partners' profit in the profit and loss ratio, thus............	10,800.00	7,200.00	18,000.00

Mr. Ratterman's method makes A's share of the expense $900.00 too large, and B's share of the expense $900.00 too small.

Mr. Ratterman might answer that this case and the case of goodwill are not analogous because the adjustment of depreciation is a correction of distributed past profits while the profit on the sale of the goodwill is a realization of speculative future profits. Suppose, however, that the purchaser paid $9,000 more than book value of the building because of the rise in market price of real estate. This would seem to be one of Mr. Ratterman's "speculative profits," and as such he would divide it equally. But everyone knows that depreciation is purely an estimate, and in all probability the $9,000 is partly an adjustment of depreciation and partly a profit due to changes in market value. Since the depreciation is an operating expense borne in the 60% and 40% ratio, Mr. Ratterman would have to divide the $9,000 into two elements: the correction of depreciation, to be divided in the profit and loss ratio, and the "unusual profit," to be divided equally. How can he make this division?

Mr. Ratterman may not consider that the principles involved in this case are the same as those involved in the division of goodwill. Let us go a step further. A partnership has a capital of $400,000 equally divided between A and B. C desires to buy and is willing to pay $500,000 because he thinks that the true capital has been decreased by excessive reserves for bad debts and depreciation, that the real estate has advanced in market value and is worth more than its book value and that the business has a goodwill. Here is a profit of $100,000 disclosed at the time of the sale. Can Mr. Ratterman divide it into its elements of corrections of usual operating profits to be divided in the profit and loss ratio and extraordinary or speculative profits to be divided in the capital ratio? Fortunately it is not necessary to make the division, as the entire $100,000 is a profit, divisible in the profit and loss ratio.

Finally, since Mr. Ratterman is an attorney, let us examine the law. The following quotation is from *Partnership,* by Frank Hall Childs:

"In settling a partnership estate the first consideration is the payment of partnership debts. All of the partnership property of every kind and character, including the goodwill of the firm, is included in the final accounting. If there is sufficient cash to pay all claims, it is not necessary to convert the other property into cash. After the payment of all claims to third parties, the firm should next repay any loans or advances made by each partner to the firm. After the repayment of such loans, the firm should next

repay to each partner his original contribution of capital. After the repayment of capital, the surplus, if any, should be divided among the partners as profits. In the absence of an agreement to the contrary the profits are divided equally."

By inference, the surplus after paying debts and capital would be divided according to the profit-sharing agreement if one existed. In the problem presented by Mr. Ratterman, the liabilities are assumed by the corporation and there are no loans from partners. With $500,000 to divide, the capitals are first paid, and a surplus of $90,000 remains "to be divided among the partners as profits."

Mr. Ratterman declares that the division of this profit in the ratio agreed to by the partners is "altogether unreasonable." It seems reasonable to us, since it conforms to the agreement; it is fair because it divides the profit on the goodwill in the ratio in which the partners contributed skill and services to its creation; it avoids the impossible task of distinguishing between corrections of prior profits to be divided in one ratio and so-called "speculative" profits to be divided in another ratio, and it complies with the requirements of the law.

Effective Rate on Serial Bonds

Editor, Students' Department:

Sir: I am a subscriber of your magazine. If it is not too much trouble would you be kind enough to tell me how Sir Arthur Lowes Dickinson arrives at 8 3/16 per cent as the effective rate in his problem on page 138 *Accounting Practice and Procedure?*

The problem reads as follows: "An issue of $1,000,000 of bonds is made at 90, carrying interest at 5%, and redeemable at the rate of $50,000 each half year, at 100 for the first five years and thereafter at 105. Calculations made on these premises show that the effective rate of interest is approximately 8 3/16%. Bonds are redeemed each year as specified, but they are purchased in the market at the following prices, viz.:

First year	$ 92
Second year	93
Third year	95
Fourth year	97
Fifth year	98
Sixth year	100
Seventh year	102
Eighth year	104
Ninth and tenth, drawn at	105"

Also kindly inform me how he arrives at $125,000 as the discount on bonds.

Yours truly,
Edward A. Murphy.

The total discount is computed as follows:

Half the bonds are redeemable at 100	$ 500,000.00
The other half are redeemable at 105	525,000.00
Total obligation	$1,025,000.00
Bonds sold for	900,000.00
Discount	125,000.00

The effective interest rate is apparently computed somewhat as follows:

90% of bonds outstanding first 6 months' period............	900,000.00
90% of bonds outstanding last 6 months' period..............	45,000.00
Sum of first and last terms..................................	$ 945,000.00
Multiply by half the number of periods......................	10
Sum of effective principals for all periods.........	$9,450,000.00

This much of the computation merely utilizes the principle of arithmetical progression as a short method of determining 90% (since the bonds were issued at 90) of the par of the bonds outstanding each period, and finding the sum thereof. The same result could be reached as follows:

First period: 90% of $1,000,000 bonds outstanding...........	$ 900,000.00
Second period: 90% of $950,000 bonds outstanding..........	855,000.00
Third period: 90% of $900,000 bonds outstanding............	810,000.00
And so on down to twentieth period: 90% of $50,000 bonds outstanding	45,000.00
Sum	$9,450,000.00

The next step is to compute the total interest to be paid during the twenty periods, which includes interest on the par of the bonds, discount on issue and premium on redemption.

Interest on par (by arithmetical progression):

First six months: 2½% of $1,000,000......................	$ 25,000.00
Last six months: 2½% of $50,000..........................	1,250.00
Sum of first and last terms..................................	$ 26,250.00
Multiply by half the number of terms......................	10
Total interest paid..	$ 262,500.00
Discount on issue..	100,000.00
Premium on redemption of last half of bonds...............	25,000.00
Total	$ 387,000.00

Of course it is understood that the effective rate is computed at the time of issuing the bonds, when the actual price at which they were eventually redeemed is not known; hence the effective rate is based on the contract prices of redemption.

Then $387,500 \div 9,450,000 = 4.10053$, the approximate rate per period.

Sir Arthur Dickinson uses 4.09375%, which is 4 3/32% per period of 6 months, or 8 3/16% per annum.

This approximate effective rate is computed on a simple interest basis, but it is applied on a compound interest basis, as indicated below:

First period: effective principal................		$900,000.00
Add interest at 4 3/32% on $900,000.00..........		36,843.75
Total		$936,843.75
Deduct coupons paid..........................	$25,000.00	
Deduct bonds paid............................	50,000.00	75,000.00
Second period: effective principal................		$861,843.75

For the second period the interest is computed at 4 3/32% on $861,843.75, although in approximating the rate it was estimated that the interest would be computed on 90% of $950,000.00, or $855,000.00. This is the reason why the amortization of the discount is not exact when using the approximate rate of 4 3/32%.

To obtain an exact amortization of the discount it would be necessary to determine the effective rate computed on a compound interest basis. Unfortunately there is no formula by which this exact rate can be computed, but it is possible to obtain a closer approximation than 4 3/32%. The approximate rate of 4 3/32% has the advantage of being easily computed. If the necessity for greater accuracy warrants the labor, a closer approximation may be obtained as follows:

Assume a trial rate as close to the true one as it is possible to guess. Compute the price at which the bonds would be issued to yield this rate. If a bond table is available showing values at the trial rate, the price can be taken therefrom. Where the bonds are redeemable serially, each redemption is dealt with separately, and the values for all redemptions are added to find the value of the entire issue at the trial rate. If a bond table is not available, or if it does not show values at the trial rate, the values may be computed by discounting all benefits to be received by the holder of the bonds (interest and par, or interest and par plus premium) at the trial rate.

If the price thus computed at which the bonds would be sold to yield the trial rate is greater than the price at which they actually were issued, the trial rate is too low. Repeat the process of computing the value at a higher trial rate.

If the price at the first trial rate is less than the price at which the bonds were sold, the trial rate is too high. Compute the value at a lower trial rate.

After obtaining two values at trial rates as close as possible to the actual selling price, but one value a little too large and the other a little too small, find the difference between the values at the two trial rates.

Interpolate between the two trial rates by adding to the smaller rate a fraction of a percent obtained thus:

$$\frac{\text{Value at smaller trial rate, minus selling price}}{\text{Value at smaller trial rate, minus value at larger trial rate}} \text{ multiplied by}$$

the difference between the trial rates.

To illustrate this procedure, the effective rate on a compound interest basis will be approximated, using the facts in Sir Arthur Dickinson's illustration, as follows:

$1,000,000 of bonds bearing 5% interest payable semi-annually.

Bonds issued at 90.

Redeemable serially; $50,000 each six months for five years at par; $50,000 each six months thereafter at 105.

Since the effective rate, 8 3/16% per annum on a simple interest basis is to large a rate on a compound interest basis, a trial rate of 8% a year, or 4% each six months, will be used. Bond tables invariably show effective rates on a compound interest basis, but they rarely show values to yield as high as 8%. Hence the value of the issue at the trial rate of 8% will be computed by discounting all benefits to be received by the holder of the bonds. Since interest is payable semi-annually, the trial rate will be 4% per period of six months. The present values of $1 at 4%, shown in the following statement, are taken from a book of interest tables:

Computation of Value of Serial Bonds

Trial rate: 8% per annum, or 4% per period of 6 months

End of period	Present value of $1 at 4% (a)	Principal and premium due (b)	Present value of principal and premium (a) × (b)	Interest due (c)	Present value of interest (a) × (c)
1....	.961538462	$50,000.00	$48,076.92	$25,000.00	$24,038.46
2....	.924556213	50,000.00	46,227.81	23,750.00	21,957.21
3....	.888996359	50,000.00	44,449.82	22,500.00	20,002.41
4....	.854804191	50,000.00	42,740.21	21,250.00	18,164.59
5....	.821927107	50,000.00	41,096.36	20,000.00	16,438.54
6....	.790314526	50,000.00	39,515.73	18,750.00	14,818.41
7....	.759917813	50,000.00	37,995.89	17.500.00	13,298.57
8....	.730690205	50,000.00	36,534.51	16,250.00	11,873.71
9....	.702586736	50,000.00	35,129.34	15,000.00	10,538.81
10....	.675564169	50,000.00	33,778.21	13,750.00	9,289.01
11....	.649580932	52,500.00	34,103.00	12,500.00	8,119.76
12....	.624597050	52,500.00	32,791.35	11,250.00	7,026.72
13....	.600574086	52,500.00	31,530.14	10,000.00	6.005.74
14....	.577475083	52,500.00	30,317.44	8,750.00	5,052.91
15....	.555264503	52,500.00	29,151.39	7,500.00	4,164.49
16....	.533908176	52,500.00	28,030.18	6,250.00	3,336.93
17....	.513373246	52,500.00	26,952.10	5,000.00	2,566.87
18....	.493628121	52,500.00	25,915.48	3,750.00	1,851.11
19....	.474642424	52,500.00	24,918.73	2,500.00	1,186.61
20....	.456386949	52,500.00	23,960.31	1,250.00	570.48
Totals..			$693,214.92		$200,301.34

The computation of the present values of the payments on principal and premium may be somewhat shortened as follows:

Sum of present values of $1 at 4% for first 10 periods = ...	8.110895781
Multiply by..	$50,000.00
Present value of first ten payments on principal..............	$405,544.79
Sum of present values of $1 at 4% for last 10 periods = ...	5.479430570
Multiply by..	$52,500.00
Present value of last ten payments on principal and premium..	$287,670.10
Present value of first ten payments on principal..............	$405,544.79
Present value of last ten payments on principal and premium..	287,670.10
Total	$693,214.89

If sold to net 8% a year or 4% per period, the bonds would have brought

Present value of par and premium..........................	$693,214.92
Present value of interest.................................	200,301.34
Total price on the basis of a trial rate of 8%.................	$893,516.26

Since $893.516.26 is less than $900,000.00, the actual selling price of the bonds, the trial rate, 8%, is too large. We shall next try 7½% per annum, or 3¾% per period.

Computation of Value of Serial Bonds

Trial rate: 7½% per annum, or 3¾% per period of 6 months

End of period	Present value of $1 at 3¾%	Principal and premium due	Present value of principal and premium	Interest due	Present value of interest
1.....	.963855422	....	....	$25,000.00	$24,096.39
2.....	.929017274	....	....	23,750.00	22,064.16
3.....	.895438336	....	....	22,500.00	20,147.36
4.....	.863073095	....	....	21,250.00	18,340.30
5.....	.831877682	....	....	20,000.00	16,637.55
6.....	.801809814	....	....	18,750.00	15,033.93
7.....	.772828737	....	....	17,500.00	13,524.50
8.....	.744895168	....	....	16,250.00	12,104.55
9.....	.717971246	....	....	15,000.00	10,769.57
10.....	.692020478	....	....	13,750.00	9,515.28
Sub-total.	8.212787252	(ave.) $50,000.00	$410,639.36	....	....

11.....	.667007690	....	....	12,500.00	8,337.60
12.....	.642898978	....	....	11,250.00	7,232.61
13.....	.619661666	....	....	10,000.00	6,196.62
14.....	.597264256	....	....	8,750.00	5,226.06
15.....	.575676391	....	....	7,500.00	4,317.57
16.....	.554868811	....	....	6,250.00	3,467.93
17.....	.534813312	....	....	5,000.00	2,674.07
18.....	.515482710	....	....	3,750.00	1,933.06
19.....	.496850805	....	....	2,500.00	1,242.13
20.....	.478892342	....	....	1,250.00	598.62
Sub-total.	5.683416961 (ave.)	52,500.00	298,379.39	....	....
Totals...			$709,018.75		$203,459.86

Summary:

Present value, principal and premium..................	$709,018.75
Present value, interest..................................	203,459.86
Total value at trial rate of 3¾% per period............	$912,478.61
Price on a basis of 3¾% per period..................	$912,478.61
Price on a basis of 4% per period......................	893,516.26
Difference due to ¼% change in the rate..............	$ 18,962.35
Price of a basis of 3¾% per period....................	$912,478.61
Price at the unknown rate.............................	900,000.00
Difference	$ 12,478.61

Then

$\frac{12,478.61}{18,962.35}$ of ¼% should be added to 3¾% to find the approximate rate per period

$\frac{12,478.61}{18,962.35}$ of ¼% = .164 + %.

Hence

3.75% the lower trial rate,

plus

.164%

3.914% the approximate rate per period,

and

7.828% is the approximate rate per annum.

If this rate were exact there would be no balance in the following schedule of amortization. This schedule illustrates the method of amortization by the scientific, effective interest method. The rate is a little too large,

causing an over-amortization of discount to the amount of $61.39. But this is a relatively small discrepancy considering the size of the loan and the amount of the discount, and it indicates that the approximate rate is very close to the exact one.

First period: effective principal		$900,000.00
Add interest at 3.914% on $900,000.00	$35,226.00	
Less coupons	25,000.00	10,226.00
Total		$910,226.00
Less payment on principal		50,000.00
Second period: effective principal		$860,226.00
Add interest at 3.914% on $860,226.00	$33,669.25	
Less coupons	23,750.00	9,919.25
Total		$870,145.25
Less payment on principal		50,000.00
Third period: effective principal		$820,145.25
Add interest at 3.914% on $820,145.25	$32,100.49	
Less coupons	22,500.00	9,600.49
Total		$829,745.74
Less payment on principal		50,000.00
Fourth period: effective principal		$779,745.74
Add interest at 3.914% on $779,745.74	$30,519.25	
Less coupons	21,250.00	9,269.25
Total		$789,014.99
Less payment on principal		50,000.00
Fifth period: effective principal		$739,014.99
Add interest at 3.914% on $739,014.99	$28,925.05	
Less coupons	20,000.00	8,925.05
Total		$747,940.04
Less payment on principal		50,000.00
Sixth period: effective principal		$697,940.04
Add interest at 3.914% on $697,940.04	$27,317.37	
Less coupons	18,750.00	8,567.37

Total		$706,507.41
Less payment on principal..................		50,000.00
Seventh period: effective principal...............		$656,507.41
Add interest at 3.914% on $656,507.41........	$25,695.70	
Less coupons..................................	17,500.00	8,195.70
Total		$664,703.11
Less payment on principal..................		50,000.00
Eighth period: effective principal................		$614,703.11
Add interest at 3.914% on $614,703.11........	$24,059.48	
Less coupons..................................	16,250.00	7,809.48
Total		$622,512.59
Less payment on principal..................		50,000.00
Ninth period: effective principal................		$572,512.59
Add interest at 3.914% on $572,512.59........	$22,408.14	
Less coupons..................................	15,000.00	7,408.14
Total		$579,920.73
Less payment on principal..................		50,000.00
Tenth period: effective principal.................		$529,920.73
Add interest at 3.914% on $529,920.73........	$20,741.10	
Less coupons..................................	13,750.00	6,991.10
Total		$536,911.83
Less payment on principal..................		50,000.00
Eleventh period: effective principal...............		$486,911.83
Add interest at 3.914% on $486,911.83........	$19,057.73	
Less coupons..................................	12,500.00	6,557.73
Total		$493,469.56
Less payment on principal and premium......		52,500.00
Twelfth period: effective principal...............		$440,969.56
Add interest at 3.914% on $440,969.56........	$17,259.55	
Less coupons..................................	11,250.00	6,009.55
Total		$446,979.11
Less payment on principal and premium......		52,500.00
Thirteenth period: effective principal............		$394,479.11
Add interest at 3.914% on $394,479.11........	$15,439.91	
Less coupons..................................	10,000.00	5,439.91

Total		$399,919.02
Less payment on principal and premium		52,500.00
Fourteenth period: effective principal		$347,419.02
Add interest at 3.914% on $347,419.02	$13,597.98	
Less coupons	8,750.00	4,847.98
Total		$352,267.00
Less payment on principal and premium		52,500.00
Fifteenth period: effective principal		$299,767.00
Add interest at 3.914% on $299,767.00	$11,732.88	
Less coupons	7,500.00	4,232.88
Total		$303,999.88
Less payment on principal and premium		52,500.00
Sixteenth period: effective principal		$251,499.88
Add interest at 3.914% on $251,499.88	$9,843.71	
Less coupons	6,250.00	3,593.71
Total		$255,093.59
Less payment on principal and premium		52,500.00
Seventeenth period: effective principal		$202,593.59
Add interest at 3.914% on $202,593.59	$7,929.51	
Less coupons	5,000.00	2,929.51
Total		$205,523.10
Less payment on principal and premium		52,500.00
Eighteenth period: effective principal		$153,023.10
Add interest at 3.914% on $153,023.10	$5,989.32	
Less coupons	3,750.00	2,239.32
Total		$155,262.42
Less payment on principal and premium		52,500.00
Nineteenth period: effective principal		$102,762.42
Add interest at 3.914% on $102,762.42	$4,022.12	
Less coupons	2,500.00	1,522.12
Total		$104,284.54
Less payment on principal and premium		52,500.00
Twentieth period: effective principal		$51,784.54
Add interest at 3.914% on $51,784.54	$2,026.85	
Less coupons	1,250.00	776.85

Total	$52,561.39
Less payment on principal and premium......	52,500.00
Balance: over-amortization of discount..........	61.39

If a still closer approach to accuracy is desired, it can be obtained as follows:

$61.39 (total over-amortization) ÷ 20 (number of periods) = $3.07 (average)

$35,226.00	interest first period (as above).
3.07	average over-amortization.
$35,222.93	closer approximation to correct interest, first period.

$35,222.93 ÷ $900,000.00 (effective principal first period) = 3.91366%

Schedule of Amortization

Period	Interest at 3.91366%	Coupons	Payment on principal and premium	Effective principal $900,000.00
1.......	$35,222.94	$25,000.00	$50,000.00	860,222.94
2.......	33,666.20	23,750.00	50,000.00	820,139.14
3.......	32,097.46	22,500.00	50,000.00	779,736.60
4.......	30,516.24	21,250.00	50,000.00	739,002.84
5.......	28,922.06	20,000.00	50,000.00	697,924.90
6.......	27,314.41	18,750.00	50,000.00	656,489.31
7.......	25,692.76	17,500.00	50,000.00	614,682.07
8.......	24,056.57	16,250.00	50,000.00	572,488.64
9.......	22,405.26	15,000.00	50,000.00	529,893.90
10.......	20,738.25	13,750.00	50,000.00	486,882.15
11.......	19,054.91	12,500.00	52,500.00	440,937.06
12.......	17,256.78	11,250.00	52,500.00	394,443.84
13.......	15,437.19	10,000.00	52,500.00	347,381.03
14.......	13,595.31	8,750.00	52,500.00	299,726.34
15.......	11,730.29	7,500.00	52,500.00	251,456.63
16.......	9,841.18	6,250.00	52,500.00	202,547.81
17.......	7,927.05	5,000.00	52,500.00	152,974.86
18.......	5,986.94	3,750.00	52,500.00	102,711.80
19.......	4,019.81	2,500.00	52,500.00	51,731.61
20.......	2,024.62	1,250.00	52,500.00	6.23
	$387,506.23	$262,500.00	$1,025,000.00	

Sir Arthur Dickinson uses this illustration to show the operation of a much shorter method of determining the periodical amortization. After discussing the effective interest method and the equal instalment method, he says (page 138):

"A third method, which may be called the bonds outstanding method, and which may safely be adopted where, by reason of complication in the terms

of issue and redemption, it is difficult or impracticable to determine the true interest rate, is to distribute the discount or premium over the period in the proportion that the bonds outstanding for each year bear to the sum of the bonds outstanding for all years of the currency of the loan. Any saving made by the purchase of bonds in the market is credited to income account."

The amortization by this method is computed as follows:

Bonds outstanding first period..................	$ 1,000,000.00
Bonds outstanding last period.................	50,000.00
Sum of first and last terms.....................	$ 1,050,000.00
Multiply by half the number of terms..........	10
Sum of bonds outstanding all periods...........	$10,500,000.00

Discount amortized:

First period...........	100/1050 of $125,000.00 =	$11,905.00
Second period.........	95/1050 of 125,000.00 =	11,310.00

And so on down to

Twentieth period.......	5/1050 of 125,000.00 =	595.00

In addition, the coupons paid each period are charged to interest, making the total as follows:

	Debit interest (total)	Credit cash (coupon)	Credit discount (amortization)
First period..........	$36,905.00	$25,000.00	$11,905.00
Second period........	35,060.00	23,750.00	11,310.00

Comparative Amortization Table

Showing total charges to interest for coupons and discount

Period	Bonds outstanding method	Scientific effective interest method (approximate rates)	
		4 3/32%	3.91366%
1..............	$36,905.00	$36,843.75	$35,222.94
2..............	35,060.00	35,001.56	33,666.20
3..............	33,214.00	33,159.38	32,097.46
4..............	31,369.00	31,317.19	30,516.24
5..............	29,524.00	29,475.00	28,922.06
6..............	27,679.00	27,632.81	27,314.41
7..............	25,833.00	25,790.63	25,692.76
8..............	23,988.00	23.948.44	24,056.57
9..............	22,143.00	22,106.25	22,405.26
10..............	20,298.00	20,264.06	20,738.25
11..............	18,452.00	18,421.88	19,054.91
12..............	16,607.00	16,579.69	17,256.78
13..............	14,762.00	14,737.50	15,437.19
14..............	12,917.00	12,895.31	13,595.31
15..............	11,071.00	11,053.12	11,730.29

16	$ 9,226.00	$ 9,210.94	$ 9,841.18
17	7,381.00	7,368.75	7,927.05
18	5,536.00	5,526.56	5,986.94
19	3,690.00	3,684.38	4,019.81
20	1,845,00	1,842.19	2,024.62
Totals	$387,500.00	$386,859.39	$387,506.23
		Under 640.61	Over 6.23
		$387,500.00	$387,500.00

While the bonds outstanding method and the effective interest method, using the approximate rate of 4 3/32%, are sufficiently accurate to be used by an industrial concern issuing serial bonds at a discount, neither method is sufficiently accurate to be used by financial institutions such as insurance companies, where exact computation of income and amortization of premium or discount on owned securities is always desirable and is often required by law. In such cases only the scientific interest method, using as close an approximation as possible to the true rate, will produce sufficiently accurate results.

The scientific method is particularly essential in cases of estates where the income is payable to a life tenant. Assume that the entire bond issue in the illustration is held by such an estate, the life tenant being paid each six months the amount of the coupons collected and the discount amortized.

Using the bonds outstanding method:

The life tenant would be paid during the first 7 periods	$219,584.00
While he should have been paid almost exactly the amounts shown in the third column of the comparative table totaling.	213,432.07
An over-payment of	$6,151.93

Using the effective interest method but with the 4 3/32% rate:

The life tenant would be paid during the first 7 periods	$219,220.32
Instead of	213,432.07
An over-payment of	$5,788.25

Editor, Students' Department:

SIR: Will you kindly answer the following question?

A corporation executed a loan September 15, 1907, of $600,000.00, for which it issued a series of 28 notes of $25,000.00 each, totaling $700,000.00, with interest at 8% per annum. The notes were due and payable one each month beginning October 15, 1907. What rate of interest was paid for the loan and bonus? What is the rate of amortization of bonus paid?

Yours truly,
STUDENT.

If it were merely desired to amortize the bonus or discount with fair

equity over the 28 months, it could be done easily by the bonds outstanding method, as follows:

Notes outstanding first period	28
Notes outstanding last period	1
Sum of largest and smallest terms	29
Multiply by half the number of terms	14
Product	406

First month: write off 28/406 of $100,000.00 bonus, or $689.66.

Second month: write off 27/406 of $100,000.00 bonus, or $665.02, etc.

But the letter asks for the rate of interest paid on the loan and bonus, the writer apparently wishing to know the effective interest rate by which the bonus may be scientifically amortized. In order to compute this rate it is necessary to make an assumption as to the payment of the interest, and I am assuming that as each note is paid the interest accrued and unpaid to date is paid also, and that each six months the interest on notes then outstanding is also paid. Therefore interest payments are made as follows:

First month: 1 month's interest at 8% on $25,000	$ 166.67	
Second month: 2 months' interest at 8% on $25,000	333.33	
Third month: 3 months' interest at 8% on $25,000	500.00	
Fourth month: 4 months' interest at 8% on $25,000	666.67	
Fifth month: 5 months' interest at 8% on $25,000	833.33	
Sixth month: 6 months' interest at 8% on $25,000	1,000.00	$3,500.00

Multiply by 4 to compute total of four series of six months each, or total monthly interest on notes paid up to and including the 24th note	$ 14,000.00
Interest 25th month	166.67
" 26th "	333.33
" 27th "	500.00
" 28th "	666.67
Sixth month: 4% on $550,000 notes outstanding	22,000.00
Twelfth month: 4% on $400,000 notes outstanding	16,000.00
Eighteenth month: 4% on $250,000 notes outstanding	10,000.00
Twenty-fourth month: 4% on $100,000 notes outstanding	4,000.00
Total interest paid in 28 months	$67,666.67
Add bonus	100,000.00
Total interest and bonus	$167,666.67

I shall use this problem to illustrate a trial and error method by which the effective rate may be computed with almost perfect accuracy and without the use of interest tables.

First, the rate will be approximated by the method used by Sir Arthur Dickinson to obtain his rate of 8 3/16%.

Effective principal, first month: 6/7 of $700,000	$600,000.00
Approximate effective principal, last month: 6/7 of $25,000	21,428.57
Sum of first and last terms	$621,428.57
Multiply by half the number of terms	14
Sum of approximate effective principals for all months	$8,700,000.00

Then $167,666.67 ÷ 8,700,000.00 = 1.936 + %, rough approximation of effective rate.

But we found in the preceding problem that this approximate rate is too large on bonds issued at a discount, because it is computed on a simple interest basis instead of on a compound interest basis. We shall, therefore, assume a trial rate somewhat smaller, and work out the amortization. Using 1.90% a month, the amortization is as indicated below:

First month: effective principal		$900,000.00
Add interest at 1.9% on $900,000		11,400.00
Total		$911,400.00
Deduct note paid	$25,000.00	
Interest thereon	166.67	25,166.67
Second month: effective principal		$586,233.33
Add interest at 1.9% on $586,233.33		11,138.43
Total		$597,371.76
Deduct note paid	$25,000.00	
Interest thereon	333.33	25,333.33
Third month: effective principal		$572,038.43
Add interest at 1.9% on $572,038.43		10,868.73
Total		$582,907.16
Deduct note paid	$25,000.00	
Interest thereon	500.00	25,500.00
Fourth month: effective principal		$557,407.16
Add interest at 1.9% on $557,407.16		10,590.74
Total		$567,997.90
Deduct note paid	$25,000.00	
Interest thereon	667.67	25,666.67

Fifth month: effective principal................		$542,331.23
Add interest at 1.9% on $542,331.23..........		10,304.29
Total		$552,635.52
Deduct note paid	$25,000.00	
Interest thereon	833.33	25,833.33
Sixth month: effective principal................		$526,802.19
Add interest at 1.9% on $526,802.19..........		10,009.24
Total		$536,811.43
Deduct note paid	$25,000.00	
Interest thereon	1,000.00	
Interest on notes outstanding...............	22,000.00	48,000.00
Seventh month: effective principal...............		$488,811.43
Add interest at 1.9% on $488,811.43..........		9,287.42
Total		$498,098.85
Deduct note paid	$25,000.00	
Interest thereon	166.67	25,166.67
And so forth down to the 28th period: effective principal		$36,716.38
Add interest at 1.9% on $36,716.38..........		697.61
Total		$37,413.99
Deduct note paid	$25,000.00	
Interest thereon	666.67	25,666.67
Over-amortization caused by too high a rate......		$11,747.32

Another attempt will now be made to approximate the rate by dividing the total interest by the sum of the approximate effective principals; but instead of using 90% of the notes outstanding each period as the effective principals we shall use the effective principals shown in the schedule of amortization at 1.9%:

First period	$ 900,000.00
Second period	586,233.33
Third period	572,038.43
Fourth period	557,407.16
Fifth period	542,331.23
Sixth period	526,802.19
Seventh period	488,811.43
Et cetera, down to twenty-eighth period..............	36,716.38
Total	$9,442,842.28

But these effective principals are too large, as shown by the fact that there is a remainder of $11,747.32 at the end of the twenty-eighth period. This excess increased in an approximate arithmetical progression from beginning of

First period	0	
Twenty-ninth	$11,747.32	
Total	11,747.32	
Multiply by ½ of 29	14½	$170,336.14
Estimated sum of effective principals		$9,272,506.14

Then 167,666.67 ÷ 9,272,506.14 = 1,8082%.

Trying 1.81%, there is a remainder or over-amortization of $9.24 at the end of the twenty-eighth period. This discrepancy is so small that for most purposes there would be no object in computing the rate to a greater degree of accuracy. If necessary, the above method can be applied again as follows:

Sum of effective principals in table of amortization at 1.81%		$9,263,861.23
Over-amortization at 1.81.%	$9.24	
One-half thereof	4.62	
Multiply 4.62 by 29, and deduct the product		133.98
Estimated total of effective principals		$9,263,727.25

Then 167,666.67 ÷ 9,263,727.25 = 1.809926 + %, the effective rate per month.

Illinois Society of Certified Public Accountants

At the annual meeting of the Illinois Society of Certified Public Accountants, September 14, 1920, the following officers were elected: president, C. R. Whitworth; vice-president, G. W. Rossetter; secretary-treasurer, John K. Laird; directors, Andrew Sangster, John Medlock, Frank M. Boughey and W. B. Castenholz.

Lybrand, Ross Bros. & Montgomery announce the opening of an office in the Book building, Detroit, Michigan, under the supervision of T. B. G. Henderson, and under the direct management of Richard Fitz-Gerald and Conrad B. Taylor.

Dennis & Young announce dissolution of partnership. W. H. Dennis announces that he will continue in practice at 87 Nassau street, New York.

Thomas J. O'Brien, Jr., announces the opening of offices in the Liberty Bank & Trust building, Savannah, Georgia.

The Journal of Accountancy

Official Organ of the American Institute of Accountants

Vol. 30 DECEMBER, 1920 No. 6

American Institute of Accountants

BOARD OF EXAMINERS

Examination in Auditing

NOVEMBER 16, 1920, 9 A. M. TO 12:30 P. M.

Answer all the following questions:

1. You are called to audit the accounts of a large railroad system. State shortly what its sources of income are, what records you would expect to find containing the details of them, how they are generally summarized in order to bring them on the books of the company, and how you would satisfy yourself of their accuracy.

2. In auditing the accounts of a large corporation you find an account with Liberty bonds, charged with $200,000.00, representing the cost of bonds subscribed and paid for by the company. At the date of the balance-sheet to which you are to certify, the bonds had a market value of $187,500.00. What attitude would you take as to their valuation in the balance-sheet?

3. What do you understand by the terms

(a) Contingent assets?

(b) Contingent liabilities?

Give three illustrations of each.

Where would you look for items?

Should they be set up on the books of the company?

Should they appear on a certified balance-sheet of the company? If so, where and how stated?

4. How may the amount of a merchant's stock on hand be

estimated from time to time when it is not practicable to take a physical inventory more than once a year?

5. State concisely your understanding of the purpose of and the difference between the following kinds of audits, indicating briefly your conception in the absence of special instruction of the extent of your responsibility in each case, whose interests you would consider yourself obligated to protect, and the forms of certificates you would expect to furnish, assuming no qualifications were desired. Except where stated to the contrary, you may assume the audits relate to a corporation.

(a) Continuous or periodical cash audit.
(b) Annual audit.
(c) Financial audit or investigation.
(d) General audit of trustees or executors' accounts for probate.
(e) Audit required under a patent infringement.

6. What steps should be taken in the most complete possible verification of the capital stock account of a corporation in an audit for a year, if during that year the authorized capital was increased and new stock was issued, and certain shares were acquired and held by the company (assuming that it is legal to do so), and if (a) there is a registrar of the stock and (b) there is not?

7. State definitely the procedure you would follow in verifying the liability of a corporation on account of notes payable as shown by its books.

8. You are engaged by bankers to undertake an investigation of a business incidental to a proposed refinancing. The instructions from the bankers are received subsequent to the date of the balance sheet to which you are expected to certify. How would you proceed to verify the asset of cash, explaining the necessity for each step?

9. Draft forms of certificates for inventory and outstanding liabilities of a manufacturing business with which you are familiar, stating nature of the business.

10. In auditing the books of a corporation you find that certain officers, apparently without any authorization, are indebted heavily to the corporation. How would you proceed in such circumstances?

Examination in Accounting Theory and Practice

Part I

November 16, 1920, 1 P. M. to 6 P. M.

Answer questions 1 and 2 and any three other questions

THE NATIONAL SHALE BRICK COMPANY, INC.

Trial balance—October 31, 1920

Allowances on sales	$ 1,500.00	
Accounts receivable	22,000.00	
Accounts payable		$ 19,000.00
Bonds—first mortgage 6%		150,000.00
Buildings:		
Tunnel kilns	150,000.00	
Periodic kilns	100,000.00	
Gas producer	50,000.00	
Dryer tunnels	10,000.00	
Mill—pans and machines	10,000.00	
Power-house	5,000.00	
Sheds and stables	2,000.00	
Cash in bank	2,000.00	
Capital—1,000 shares at $100.00 each		100,000.00
Coal on hand	1,200.00	
Discounts on sales	4,500.00	
Gas coal used—kiln firing	55,000.00	
Horses and carts	1,000.00	
Inventory—bricks, November 1, 1919	5,711.75	
Interest on bonds	6,750.00	
Insurance	2,500.00	
Labor:		
Quarry	12,000.00	
Pans and machines	36,000.00	
Dryer	8,000.00	
Setting	27,000.00	
Kiln firing	65,000.00	
Unloading, etc.	30,000.00	
Power	7,000.00	
Materials and supplies used:		
Pans and machines	15,000.00	
Quarry	3,000.00	
Dryers	1,500.00	
Setting	750.00	
Kiln firing	3,000.00	
Unloading kilns, etc.	4,000.00	
Power	5,000.00	

Machinery and equipment:		
Pans and machines	$50,000.00	
Power-house	15,000.00	
Quarry	10,000.00	
Materials and supplies on hand	1,800.00	
Office supplies and expenses	2,500.00	
Prepaid taxes	600.00	
Payroll		$ 3,500.00
Quarry rentals paid in advance	7,500.00	
Sales—brick		415,000.00
Sales—coke—net		7,000.00
Sales—broken and spoiled brick—net		2,000.00
Salaries—officers'	10,000.00	
Salaries—office	4,000.00	
Steam coal used:		
Drying	5,000.00	
Power	6,000.00	
Quarry	2,000.00	
Superintendence	10,000.00	
Taxes	3,000.00	
Reserve for depreciation		25,000.00
Unexpired insurance	750.00	
Surplus		53,061.75
	$774,561.75	$774,561.75

The foregoing is the trial balance of the National Shale Brick Co., Inc., manufacturers of shale bricks. The operations consist of (1) blasting, digging and conveying the shale to the machines, called quarrying, (2) grinding, mixing and moulding the wet bricks, called pans and machines, (3) drying, (4) building the bricks in the kiln and preparing the kiln for firing, called setting, (5) burning or kiln firing, (6) opening the kiln and unloading and stocking the burnt bricks, called unloading.

The kilns are equipped with gas burners, the gas being produced on the premises. Some coke is obtained from the gas producer, which is sold.

The production reports for the year ended October 31, 1920, are:

Wet bricks produced	18,000,000
Good and carried to dryers	17,600,000
Spoiled in drying	850,000
Spoiled in burning	830,000
Set in kilns	16,000,000

Bricks sold during the year were 14,500,000.

The inventories of bricks on hand November 1, 1919, were as follows:

Burned bricks in yard..........	55,000 @	$16.25	$ 893.75
Burned bricks in kilns.........	200,000 @	14.75	2,950.00
Bricks burning in kilns.........	100,000 @	10.20	1,020.00
Green bricks in kilns...........	80,000 @	7.10	568.00
Green bricks in dryers.........	50,000 @	5.60	280.00
			$5,711.75

The candidate is required to calculate the number of bricks on hand October 31st, but is advised that, of the total, 100,000 are in the kiln completely burned, 250,000 are in process of burning, 100,000 green bricks are in the kiln. Bricks in process of burning and drying are taken as averaging half the process. Shale and wet bricks from the machine are used as produced and no inventory is taken into account.

The inventories are priced at cost. In the case of burnt bricks work overhead is included; in other cases it is excluded.

The shale bed is rented, rental being payable at the end of each year on the tonnage used. This is calculated at the rate of 3½ tons per thousand wet brick and the rate is 10 cents per ton. The agreement provides for a minimum rental of $4,000.00 per annum. In case the quantity of shale used is not sufficient to make the $4,000.00 the company is allowed to retain the difference out of subsequent years in which the quantity used may amount to more than $4,000.00.

Depreciation:

	Per cent per annum
Tunnel kilns	7½
Periodic kilns	10
Gas producer	10
Dryer tunnels	7½
Machinery equipment	10
Other buildings	5
Sheds and stables	20

Power is divided 10% to kiln firing, 90% to pans and machines.

Prepare statements showing cost of manufacture, cost per thousand bricks for each operation, profit and loss account and balance-sheet.

2. (2) The X Y Z company established for ten years has a

machinery and equipment account which has been increased from year to year as new equipment purchases have been made. It appears also that certain renewals and repairs have been charged to this account. Each year a credit has been made to the account for depreciation, offset by corresponding debit to profit and loss account, the ratio of depreciation being adequate. The company now disposes of a part of its plant at a price equal to what was paid for it seven years previously and credits the entire amount to machinery and equipment account. What adjustments, if any, are needed to correct the account?

(b) The company also has several delivery trucks charged to truck account at cost, against which it has set up depreciation at end of each year by credit to a separate reserve for depreciation of trucks, debiting the amount to profit and loss account. A truck was purchased January 1, 1918, for $4,000.00. Depreciation has been provided at 20% per annum. On December 31, 1919, the truck is wrecked by collision. $1,000.00 is obtained from the insurance company and $250.00 obtained from salvage. What entries are needed to adjust the ledger accounts?

3. In a certain department of a large dry-goods house the purchases for a year were $30,000.00. They were in the first place marked up for "selling" purposes to $45,000.00. Later additional mark-ups amounting to $2,000.00 were made and mark-downs were also recorded aggregating $5,000.00. At the end of the fiscal period there were found to be on hand goods of the marked selling value of $10,000.00. State how you would ascertain their inventory value for the purpose of closing the books and calculate the amount. Explain fully.

4. Mr. Richard Roe, a married man, requests you to prepare his federal income-tax return for the ten months ended December 31, 1919, from the following information which he has submitted to you:

INCOME RECEIVED DURING THE YEAR

Salary	$5,000.00
Directors' fees	105.00
Rent of property (net)	7,596.54
Interest on investments	1,648.32
Dividends on bank stock	2,500.00
Dividends on stock held in industrial companies	11,500.00
Dividends on stock of a corporation organized and doing business in a province of Canada	1,500.00

He has paid out:

Interest on his personal indebtedness	$2,500.00
Taxes on income-producing real property	1,600.00
Taxes on real property not producing income	400.00
Personal household expenses	2,500.00

He also reports:

Loss of a dwelling house, from which he had received rents, by fire, no insurance being carried	1,200.00
Judgment rendered against him in his suit to collect on the past due note of Harry Hanson—	
Principal	2,000.00
Interest	320.00
Legal expenses	150.00
	$2,470.00

State the resultant tax. The rates for individual taxes for 1919 were:

First $4,000.00—4%, thereafter 8%

Surtax

			Per cent
$ 5,000.00	to	$ 6,000.00—	1
6,000.00	"	8,000.00—	2
8,000.00	"	10,000.00—	3
10,000.00	"	12,000.00—	4
12,000.00	"	14,000.00—	5
14,000.00	"	16,000.00—	6
16,000.00	"	18,000.00—	7
18,000.00	"	20,000.00—	8
20,000.00	"	22,000.00—	9
22,000.00	"	24,000.00—	10
24,000.00	"	26,000.00—	11
26,000.00	"	28,000.00—	12
28,000.00	"	30,000.00—	13

A married man is entitled to an exemption of $2,000.00.

5. The balance-sheet of the Rozinante Company at June 30, 1920, was as follows:

Assets		*Liabilities*	
Plant and equipment	$15,000.00	Capital stock	$25,000.00
Merchandise	3,000.00	Accounts payable	2,000.00
Cash	1,000.00		
Deficit	8,000.00		
	$27,000.00		$27,000.00

A and B buy the entire stock, new certificates being made out to them in equal proportions. The price agreed upon is $20,000.00, of which $15,000.00 is paid in cash, the balance being represented by a joint and several note for $5,000.00 signed by A and B. In addition, the former stockholders, X and Y, as part of a contract, are allowed to withdraw the $1,000.00 cash shown in the above balance-sheet.

Without consulting an accountant, A and B open a new set of books, but are uncertain how much to credit capital stock. They therefore ask the former stockholders what their $25,000.00 credit to capital stock represents, and are informed that "it was the amount we paid for the stock of the corporation when it was organized." Acting on this information they credit capital stock with the price they agreed to pay for it, opening new books by the following journal entry:

Plant and equipment	$15,000.00	
Merchandise	3,000.00	
Goodwill	9,000.00	
Capital stock		$20,000.00
Accounts payable		2,000.00
Notes payable to X and Y.......		5,000.00

As the corporation is in need of funds an attempt is made to borrow $1,500.00. The bank will not accept the corporation's note but offers to lend $750.00 to A and the same amount to B on their personal notes. The notes are issued and the cash deposited in bank to the credit of the corporation. A and B agree that this $1,500.00 shall be considered "an additional investment" and an entry is made debiting cash and crediting capital stock, $1,500.00.

When the notes mature a cheque for $1,500.00 is drawn on the corporation's bank account, but the bookkeeper does not know what account to charge and asks for your advice. Upon investigation you find the facts as set forth above.

Comment on the propriety of the transactions and the entries and state what entries you would advise the bookkeeper to make.

6. The following letter is received by a practising accountant from a man not previously known to the former.

"I am contemplating the purchase of a business, the proposal of the present owner being that I pay him a flat price of $500,-000.00. He states that the plant and real estate are worth $200,-

000.00, the inventories and accounts receivable $250,000.00 and the cash $30,000.00. The liabilities of the business which would be assumed by the purchaser amount to $120,000.00. The profits are said to be good and stable.

"The nature of the business apeals to me and I am much interested in the proposition, but I have never had any experience in such matters and cannot make up my mind. I do not know how to determine what the business is worth or what dangers are involved in taking over a business in this way. My lawyer has suggested to me that public accountants are generally employed in such circumstances. Not having engaged any in the past I do not know in just what way their services would be useful to me in making up my mind or in taking delivery if I should accept the proposition.

"Will you kindly advise me in the matter?"

Write an answer to the above letter.

Examination in Commercial Law

NOVEMBER 17, 1920, 9 A. M. TO 12:30 P. M.

Give reasons for all answers

NEGOTIABLE INSTRUMENTS

Answer three of the following four questions:

1. Is the following a negotiable instrument?

Boston, Mass., July 1, 1920. One year after date, for value received, the Y. Z. corporation promises to pay to the order of Adam Brown three thousand dollars with interest at the office of the Y. Z. corporation, Boston, Mass., or, at the option of the holder thereof upon the surrender of this note, to issue to the holder hereof in lieu thereof thirty shares of the preferred stock of said Y. Z. corporation and to pay to the holder hereof in cash the interest then due upon said sum. The Y. Z. Corporation, by Y. Z., President.

2. What is the effect of indorsement of a negotiable instrument

(a) by an infant?

(b) without consideration, by a corporation?

3. A sold his automobile to B, warranting it to be a 1918 model in good mechanical condition. B gave A his note in payment of

the purchase price, of which note C became the holder in due course. B, after a few days, found that the automobile was a 1917 model and in such defective condition that its actual value was but a small proportion of the purchase price paid by him, of all of which X had knowledge. X subsequently purchased the note from C. Could he enforce the note against B?

4. How may a "qualified endorsement" be made and what is the effect of such an endorsement?

Contracts

Answer both the following questions:

5. A entered into the following agreement with the R. S. Cement company:

"Memorandum of agreement made this 6th day of July, 1905, between A, first party, and R. S. Cement company, second party, to wit, first party agrees to give the 'R. S.' brand cement the preference in his sales of cement for the year 1905, and, in consideration thereof, second party agrees to sell said brand of cement to the first party during the year 1905 at the price of 95 cents a bbl. f. o. b. Haverstraw, New York."

A ordered several shipments of cement which were duly delivered and paid for. Subsequently the market price for cement rose and the cement company notified A that it would furnish no more cement under the agreement. A then purchased his cement elsewhere during the remainder of the year at higher market prices, and he sought to recover from the cement company as damages the difference between the cost of the cement purchased by him at the prevailing market price and what the cement would have cost at the price provided in the agreement. Could he recover?

6. Define

(1) a joint contract.

(2) a joint and several contract, and point out the rights of the respective parties under each.

Corporations

Answer both the following questions:

7. In what circumstances are directors of a corporation authorized to declare dividends, and what are the liabilities of directors for declaring an unauthorized dividend?

8. The X corporation owns certain personal property of which B has wrongfully taken possession. A owns all of the stock of the X corporation and brings in his own name an action to recover the property from B. Is A entitled to recover?

Partnership

Answer one of the following two questions:

9. A, B and C form a partnership, each by mutual agreement contributing equally to the original capital. Later C furnished various further sums to the partnership to prevent financial difficulties, the partnership finally being obliged to make an assignment for the benefit of its creditors. What are C's rights with regard to the additional sums furnished by him?

10. C is admitted as a partner in a partnership composed of A and B on contributing a certain amount to the partnership capital. Prior to C's admission, the partnership of A and B incurred a large obligation which subsequent to C's admission as a partner the partnership assets were insufficient to satisfy. A and B having no financial responsibility, X seeks to satisfy his claim out of the individual assets of C. Can he succeed?

Bankruptcy

Answer the following question:

11. On examining the books of the Y corporation you find a judgment in favor of the corporation against A for $1,000.00 recovered on December 10, 1919. You also find that on July 16, 1920, A filed a voluntary petition in bankruptcy showing assets (both real and personal property) amounting to several thousand dollars, and liabilities consisting, in addition to the judgment, of amounts due on various promissory notes and open accounts. How would you treat the judgment in preparing a financial statement for the corporation?

Federal Income Tax

Answer the following question:

12. In 1909 A and B formed a corporation for the purpose of conducting the business then carried on by them under a partnership, each taking equally shares of the capital stock. B died on June 1, 1917, bequeathing his shares of stock to his son Z by will. Because of B's death the corporation ceased active business and

began to liquidate. From time to time assets were disposed of and dividends were declared and paid from the moneys received. What is the status of such dividends for federal income-tax purposes

(1) as regards A?

(2) as regards Z?

Examination in Accounting Theory and Practice

Part II.

November 17, 1920, 1 P. M. to 6 P. M.

Answer questions 1, 2, 3 *and any three other questions*:

1. You are requested by the president of a corporation to assist in the preparation of the federal income and excess profits tax return of his company for the calendar year 1919, and for the purpose thereof the following data are submitted to you:

THE NOVEMBER CORPORATION

CONDENSED TRIAL BALANCE (AFTER CLOSING)

For the year from January 1, 1919, to December 31, 1919

Particulars	*January 1*		*December 31*	
	Dr.	*Cr.*	*Dr.*	*Cr.*
Properties	$2,500,000		$3,500,000	
Depreciation reserve		$500,000		$700,000
Goodwill acquired for stock	1,500,000		1,500,000	
Investments in stock of other corporations at cost—				
Domestic corps. (25% interest)	250,000		250,000	
Foreign corps. (20% interest)	100,000		100,000	
Inventories	3,000,000		5,000,000	
Inventory reserves		500,000		1,000,000
Receivables	2,500,000		3,000,000	
Bad debt reserves		100,000		250,000
Cash	1,400,000		2,000,000	
Bond discount	90,000		80,000	
Commission paid on issue of common stock	60,000		60,000	
Prepaid expenses	50,000		40,000	
Preferred stock		1,500,000		1,125,000
Common stock		2,500,000		4,500,000
Bonds		1,000,000		1,000,000
Current liabilities		1,600,000		1,105,000

Provision for federal income and profits taxes		$ 700,000		$ 2,000,000
Contingent reserve....		250,000		250,000
Preferred stock redemption fund......		150,000		525,000
Earned surplus........		2,150,000		2,575,000
Capital surplus resulting from appraisal of properties.......		500,000		500,000
	$11,450,000	$11,450,000	$15,530,00	$15,530,000

STATEMENT OF PROFITS AND INCOME

For the year ended December 31, 1919

Sales		$25,000,000.00
Less cost of sales		15,000,000.00
Gross profit		$10,000,000.00
Deduct selling, general and administration expenses:		
Selling expenses		$ 3,500,000.00
Advertising		500,000.00
Collection expenses		200,000.00
Contingent losses on bad and doubtful accounts.........		200,000.00
General office salaries		100,000.00
Profit-sharing bonus of executives		250,000.00
Taxes:		
Real and personal property taxes..................		50,000.00
Capital stock tax		5,000.00
Special assessments		10,000.00
Life insurance policy premiums		5,000.00
Charitable contributions:		
Public subscriptions		25,000.00
Employees' welfare		30,000.00
Total expenses		$4,875,000.00
Net profits from operations		$5,125,000.00
Add other income:		
Dividends received from domestic corporations	$100,000.00	
Dividends on foreign investments..........	50,000.00	
Interest received	10,000.00	160,000.00
		$5,285,000.00

Deduct:		
Interest paid	$250,000.00	
Proportion of bond discounts written off	10,000.00	260,000.00
Net profits and income		$5,025,000.00
Deduct:		
Expenses in connection with issue of capital stock	$50,000.00	
Provision for federal income taxes (preliminary estimate)	2,000,000.00	
Special reserve against inventory	500,000.00	2,550,000.00
Surplus net profits		$2,475,000.00

SURPLUS ACCOUNT

For the year ended December 31, 1919

Balance at the beginning of the year			$2,650,000.00
Net profits for year			2,475,000.00
			$5,125,000.00
Less:			
Excess of 1918 federal taxes actually paid over amount provided at December 31, 1918		$100,000.00	
Cash dividends paid on preferred stock:			
January 31, 1919	$20,000.00		
April 30, 1919	20,000.00		
July 31, 1919	20,000.00		
October 31, 1919	15,000.00	75,000.00	
Dividends paid on common stock:			
In cash:			
February 28, 1919	$250,000.00		
August 31, 1919	250,000.00	500,000.00	
In stock:			
August 31, 1919		1,000,000.00	
Preferred stock redemption fund		375,000.00	2,050,000.00
			$3,075,000.00

You are also informed that the company was organized on January, 1, 1910, with an authorized and issued capital of $4,150,000.00, divided as to

Preferred stock	$1,650,000.00
Common stock	2,500,000.00

You are further informed that of this capital $1,000,000.00 common stock was sold to an underwriting syndicate for cash at par, less 6% commission, and that the remainder of the stock was issued to the vendor company in acquisition of the business, property, goodwill and other assets taken over. The capital stock outstanding has been unchanged from the date of organization to January 1, 1919, except as to the redemption of the preferred stock indicated, which took place March 31, 1917. The book values of the fixed properties are based on an appraisal made by an appraisal company as at March 1, 1913. In addition to the common stock dividend paid during the year, the company issued a further $1,000,000.00 common stock, which was sold for cash at par as follows:

August 31	$500,000.00
October 31	500,000.00

On October 31, 1919, it also redeemed for cash and retired preferred stock at par to the amount of $375,000.00.

You may assume the company was not engaged on any government contracts throughout the year 1919.

Prepare draft statements showing

(1) The amount of the company's "invested capital" for the year, which the treasury authorities will recognize for the purpose of computation of taxes.

(2) The taxable net income for the year.

(3) The amount of income and excess profits taxes assessable for the year.

Excess profits exemption for 1919 was 8% of invested capital plus $3,000. Excess profits rates for 1919 were:

First bracket	20%
Second "	40

Income following in first bracket is that portion thereof not exceeding 20% of invested capital. Income-tax rate for 1919 was 10%, with exemption of $2,000.

2. A company was incorporated as of January 1, 1920, to take over certain mines. The properties had been operated for some time by a receiver, the bondholders having bid in the properties at a foreclosure sale through a committee which turned over the properties to the new company.

The plan of reorganization provided for the issuance to the

bondholders of the old company of $1,000,000.00 preferred stock and 10,000 shares of common stock of no par value of the new company, being its entire capitalizaton. An arrangement was made whereby the stockholders receiving such securities returned to the treasury of the new company as a donation 2,500 shares of common stock with the understanding that such shares should be issued to the president for services to be rendered during the next five years, delivery of such stock to be made to him 1/5 at the end of each year.

The properties and assets acquired by the new company were as follows:

Mines and fixed properties	$1,800,000.00
Current assets	300,000.00
	$2,100,000.00
Less current liabilities	200,000.00
Net assets	$1,900,000.00

(1) Prepare an opening entry to record the acquisition of the properties and capitalizaton.

(2) How would you treat the 2,500 shares donated by the stockholders?

(3) How would the accounts of the next five years be affected by delivery to the manager of 1/5 of such donated stock at the close of each year?

3. The officers of the A. company find that they are unable to meet current obligations and a receiver is appointed on April 28, 1919. The receiver calls for an inventory and a statement as at date of appointment, which is given as follows:

Assets		*Liabilities*	
Machinery and equipment	$507,300.00	Reserve for depreciation	$ 7,300.00
Consigned merchandise	220,000.00	J. Smith & Co.	250,000.00
Merchandise at mill	115,000.00	Bank loans	105,000.00
Cash	800.00	Acceptances	15,000.00
Accounts receivable	1,400.00	Bank overdraft	1,000.00
Unexpired insurance	800.00	City taxes accrued	4,000.00
Employees' Liberty bonds	4,700.00	Collateral notes payable	4,700.00
		Mortgage on machinery	100,000.00
		Accrued interest on mortgage (to date)	3,000.00
		Lease—machinery	30,000.00

	Accrued interest on lease agreement	$ 10,000.00
	Accounts payable	110,000.00
	Capital stock—common	100,000.00
	Capital stock—preferred	100,000.00
	Surplus	10,000.00
$850,000.00		$850,000.00

On November 20th the receiver having disposed of all assets for cash (except consigned merchandise and $400.00 accounts receivable which were considered doubtful) calls upon you to prepare an interim statement for the information of the stockholders and creditors.

He leaves the form to your judgment but suggests that it be as concise as possible and that you show his valuations, as well as book value, at date of receivership. He also wants a summary of his transactions, not necessarily to include profit or loss showing, and finally wants the statement to show conditions as they are at date you are called in.

You find that the collateral notes payable were for accommodation of employees and were secured by deposit of bonds, also the property of employees, as per statement. The bonds have now been delivered to the employees and the notes paid by them.

The court has authorized payments of the city taxes and accrued interest of $400.00, which latter amount had been omitted from the statements but included by receiver in his valuation statement. Federal taxes were also found to be due and were also paid (amount $1,000.00).

The lease covered machinery worth $30,000.00, but the firm that furnished this machinery has accepted a release of the A. company's equity in this machinery as full payment of notes under lease agreement and the accrued interest.

The receiver finds that J. Smith & Co.'s account represents advances on the entire consigned merchandise and that this merchandise has been pledged to secure this claim in part (to the extent of value of the merchandise). Receiver accepts book value for purpose of his records.

After removal of the leased machinery the remaining machines and equipment were sold for $200,000.00 and the mortgage (and accrued interest to date of payment, $5,000.00) were paid in full.

(Receiver's original value placed upon all machinery was $200,000.00.)

The merchandise at the mill was valued by the receiver at $75,000.00, but after six months' operation the amount on hand was sold without inventory for $25,000.00.

The accounts receivable were valued by the receiver at $1,000.00 and the amount was in fact realized in cash, the balance appearing doubtful.

Unexpired insurance is accepted by receiver at book value. November 10th a rebate of $100.00 was received and all policies were canceled.

Upon comparing the statement with the books you find accounts payable understated $10,000.00 in the statement given receiver because of an error on the part of a bookkeeper when closing books at April 28th.

Claims were duly filed for entire amount owing (except $10,000.00 accounts payable). An account in purchase ledger was disallowed and is in dispute (amount, $5,000.00).

The receiver sold merchandise to the amount of $75,000.00 all of which had been paid for. Other receipts were rent for portion of building—sublet—$1,000.00; unclaimed wages, $500.00; interest on bank account to November 20, 1919, $200.00; cash surrender value of insurance policy on life of treasurer, $1,000.00.

Other payments were receiver's accounts payable, $50,000.00; taxes, $3,000.00 (assessed since receivership); rent, $2,000.00; legal expense, $5,000.00. No fee has been allowed receiver or will be considered in your statement.

An analysis of the ledger determines the fact that only the following bills and expense vouchers had been carried through the invoice register since receivership, and all had been paid promptly, viz: labor, $20,000.00; materials, $20,000.00; shop expense, $3,000.00; heat and power, $2,000.00; freight, $1,000.00; general expense, $4,000.00.

4. Indicate by appropriate journal entries, the various debits and credits you would make in setting up the following reserves for a balance-sheet, explaining briefly how you would determine the proper amount of each reserve.

(a) Reserve for bad and doubtful debts.

(b) Reserve for trade discounts.

(c) Reserve for cash discounts.

(d) Reserve for state, county and city taxes accrued.

5. It is now becoming quite common practice for corporations to insure the lives of their principal officers, so that upon their deaths the corporations may be in a measure reimbursed for the loss to the business. You are asked to indicate what sort of entries would be made by a company, from time to time, if it paid the insurance premiums on a policy of insurance for $50,000.00 carried on the life of its president under the four classes of insurance policies indicated below:

10-year renewable term policy.
20-payment life policy,
Straight life policy,
20-year endowment policy.

Also indicate what entries should be made in the books for the receipt of the $50,000.00 principal of the different classes of policies, supposing the president of the company died during the fifth year of the insured term.

6. In examining the accounts of a corporation engaged in the manufacture of a variety of articles in respect of which a specification cost system is maintained as an integral part of the bookkeeping (which, so far as inventories and cost are concerned, forms the basis of the monthly financial accounts comprising balance-sheet and profit and loss account), you find a large discrepancy between the total value of the physical inventory of manufactured stock and work in progress, as priced at specification costs, and the corresponding general ledger account, the physical inventory value being substantially less than the relative book values. What investigation would you expect to make to ascertain the cause of the discrepancy? What factors would you expect to find contributing to it, and how would you dispose of this discrepancy, and upon what theory would you recommend that adjustment be made?

Actuarial Question (Optional)

7. What could a purchaser who wished to realize 3 per cent. on his investment give for a bond for $10,000.00 which had four years to run at 5 per cent. interest payable yearly, and thereafter was repayable with a bonus of 10%.

Cost Accounting for the Motion-picture Industry

By William S. Holman

The motion-picture industry is divided broadly into three phases: the producing, distributing and exhibiting—corresponding to the manufacturing, wholesaling and retailing branches of the ordinary industry. This article will attempt to treat of the accounting features of the producing end only.

Many of the larger organizations engage in both the producing and distributing phases of the industry, and a less number in all three. In such cases the distributing and exhibiting phases are usually carried on by subsidiary or controlled companies, or the producing company is itself a subsidiary of a large distributing company.

Producing companies fall largely into two classifications: first, the company which produces pictures and distributes them either itself or through a subsidiary company and, secondly, the company, commonly termed an independent producer, which either makes a picture and then disposes of it outright to a distributing company or produces for a distributing company, under contract, one or a series of pictures. In this latter instance, the distributing company ordinarily advances to the producer a fixed sum to cover the cost of production, and then takes over the exploitation and distributing of the picture, the proceeds thereof, after recouping the advance, to be shared by the producer and distributor on a predetermined basis.

Another distinction that might be made in the case of producing companies is that between the company which is engaged upon the production of more than one picture, and in many cases a large number of pictures at the same time, and the company which produces one picture at a time. Under the latter classification will fall the companies formed for the purpose of producing pictures featuring one particular star, as well as a number of smaller producing units. A number of the best-known stars have their own companies and make only one picture at a time, and in some cases only three or four pictures a year. In this case not

many accounting problems will be presented and no very involved cost system will be required. All production costs will be charged against the one picture in process, and fixed charges for the year will be distributed over the pictures made within that year on the basis of time spent upon the production of each or upon the basis of the direct cost of each picture.

Costs are not the subject of as great concern in the motion-picture industry as they are in many others, and in most cases it is doubtful if comparative costs of different pictures are very closely scrutinized. However, in the cases of companies engaged in the production of a number of pictures at the same time costs of particular pictures are a matter of considerable concern, and this is also the case where pictures are made for distributing companies on the "cost plus" basis above mentioned. The benefits derived from having accurate and trustworthy records as to the cost of individual jobs in this industry as well as in any other are too obvious to require mention, but it is, undoubtedly, a fact that accurate costs have not always been obtained.

Direct costs for particular pictures are gathered in much the same way as in the manufacture of other articles, by purchase records, time and labor reports and reports of materials used.

Wages, because of the salaries customarily paid actors and directors, constitute the heaviest item of expense, followed by the cost of "sets," a large part of which is also made up of wages because of the labor involved therein.

It might be well to take up at this time the various items of direct cost in the order of their occurrence.

First comes the cost of the story used in the picture. Pictures are now to a great extent based on a published short story, novel or play. In other cases scenarios are purchased from outside sources. The cost of acquiring the motion-picture rights to these, oftentimes amounting to a considerable sum, is the initial cost of a picture. To this should be added charges covering salaries of continuity writers who adapt the story to the screen and work it up into the script used by the director of the picture. To this might be added a portion of scenario department expense based on the time given over to the various stories. Again the story may be written by a member of the scenario department. Here also salary charges and a proportion of scenario department

expense would be direct costs. These costs would be gathered from time reports submitted by the scenario department.

Next come the actual production charges. Antedating these, however, may come other salary costs, since the director is usually assigned to a picture some time before production commences. His salary should be charged to the picture from the date of this assignment, as he will be engaged in the preliminary work of becoming familiar with his script, helping plan his sets, etc. Salaries of actors should also be charged to the picture from the time they are assigned to it—unless actually working in another picture—especially if engaged for the particular production.

At the end of each week the production manager will report to the office the directors, assistants and cameramen and assistants assigned to each picture, which will be made the basis of salary distribution on the payroll. Each day the assistant director will report the actors and actresses engaged for or assigned to his picture, or the casting director at the end of the week will submit a report of the days worked in each picture by each actor. These reports will similarly be made the basis of salary distribution by pictures. The salary of any of the staff or talent not engaged in or assigned to any picture will be charged to an account called "salary of idle staff and talent," which will be one of the indirect expense accounts discussed later.

The first production charges will be for the cost of sets built for the picture. Lumber, wall-paper and paint will be charged to stock accounts when purchased. Each day the carpenter and paint foreman will turn in reports as to the various materials used that day. Ordinarily the requisition-on-the-stockroom method of charging materials used would not be practicable. Costs will be computed in the office and at the end of the week the reports summarized by pictures and the total cost of materials used in each picture will be charged by means of journal entries and a credit will be passed to the materials and supplies accounts.

Workmen engaged in the construction of sets will report each day the time spent upon sets for each picture, each picture having a number assigned to it. These reports will be accumulated in the office and preferably worked up each day, so as to show what part of each workman's wage is chargeable to each picture. At the end of the week a summary will be made and the payroll will

be distributed on the basis of the total amount chargeable to each picture for each workman for the week. (All salaries are usually paid weekly in this industry.)

Next in order will be the cost of properties used in dressing the sets, which with the exception of certain stock articles are ordinarily rented. If, when the purchase or rental order is issued, notation is made thereon of the number of the picture for which the article is secured, the cost or rental charge can be charged direct to the picture through the purchase register, as will be explained later.

Then will come the salaries of property men, drapers, etc., engaged in preparing the sets, and then salaries of property men, electricians and others assigned to each picture during its production. These costs will likewise be gathered by time reports turned in each day, which will be accumulated and summarized at the end of the week so that the total time spent by each man upon the various pictures is known and made the basis of the distribution of the salary paid for the week. There will be salaries for nearly all the classes of labor mentioned above, which are not chargeable to any particular picture. These will be charged to appropriate accounts and distributed in the manner outlined for indirect costs.

The cost for rental of costumes used in the pictures will be handled in the same manner as the cost of properties. If the studio itself maintains any considerable wardrobe and stock properties for use in pictures a charge for such use may be computed on the basis of the estimated useful life of the article, drawn up in schedule form. The picture will then be charged rental for its use from reports as to the time used submitted by the wardrobe and properties departments. The credit would be passed to a special account, which would be an offset to the amount chargeable as depreciation at the end of the year. Such a refinement, however, would hardly be warranted except in the case of highly perishable articles.

The cost of negative film used in the picture can be gathered from the cameraman's daily report as to film used, and the cost of developing and printing film from invoices from the laboratory, the picture number being shown on all invoices. Time reports will cover the cost of cutting and patching film, and the cost of

titles will be secured from invoices or time reports depending upon whether this is done by the studio or on the outside.

The last item of direct expense will be the cost of labor expended in tearing down sets, which will be gathered, of course, from time reports. If the lumber and other materials used have any salvage value remaining, this value should be passed as a credit to the picture and charged to an account termed, perhaps, "salvaged materials." If subsequently used in another picture the item would be charged out at this value.

The rates for employees' compensation insurance are high in this industry, and since the premiums paid are based on the amount of the payroll they may be computed and charged direct.

Fire and damage insurance is usually carried on each production, and this would also be a direct cost.

An item of cost which sometimes amounts to a considerable sum is that of location expense. The cost of maintaining or renting automobiles used in going to or from location, railroad fares, lunches, fees and similar items would be included in this expense. Such items would ordinarily be paid by an assistant director and be charged to the picture by means of a statement of cash disbursed submitted by him.

Another item which might be treated as a direct charge would be the cost of operating electrical equipment used for lighting effects. The expense for current, depreciation of equipment, etc., might be reduced to an hourly charge for use and so be charged direct. Wages of operatives are, of course, a direct charge, as has previously been mentioned.

Plant overhead, as explained later, may also be reduced to an hourly or daily charge for studio or stage rental and be charged to the picture on the basis of the time occupied by it.

A suggested outline for the classification of ledger accounts for direct costs follows, arranged by primary, secondary and subordinate accounts. Any of these accounts, of course, may be further subdivided, or other accounts may be added whenever desirable. These accounts should be appropriately numbered, as for instance, the control account 50, the secondary accounts 50A, 50B, 50C, etc., and the sub-accounts under each secondary account 50A-1, 50A-2, etc.

Direct charges (control account)
  Cost of story (secondary account)
    Scenario purchase (sub-account)
    Scenario and continuity salaries
    Scenario and continuity expense
  Salaries and wages
    Cast (actors carried on regular payroll)
    Talent (extras engaged for picture)
    Staff (directors, assistants and cameraman and assistants)
    Technical (property men, electricians, etc.)
  Sets
    Materials and supplies
    Labor (carpenters, painters, paperhangers, etc.)
  Properties
    Rental
    Purchase and damage
  Wardrobe
    Rental
    Purchase and damage
  Wardrobe and property room expense
  Rental of equipment
  Location expense
  Film
    Negative
    Developing
    Printing
    Cutting and patching
    Titles
    Expense
  Insurance
  Proportion of indirect expense and plant overhead (to be discussed later).

The control account in this case is direct charges. Now, if picture cost sheets were ruled so as to provide a total column and a column for each of the expense sub-accounts above given, each picture having assigned to it a separate sheet, many advantages which will be pointed out would result.

First, to obtain the full benefit of these advantages and to

effect a large saving in time and labor the picture costs sheets, which should be kept in a loose-leaf ledger controlled by the account direct charges, should be posted from the same media as the ledger accounts. This can be done readily by providing in the purchase or voucher register, payroll, cashbook and journal a special column for showing the picture number in the case of all items going into these picture cost expense accounts, which could also be carried out into one special column.

When this column is summarized at the end of the week for posting to the individual direct cost expense accounts above shown, it should also be summarized so as to show the total of each sub-account for each picture. The totals for each account would then be posted to the proper general ledger accounts and the total for each picture of each class of expense would be posted in the corresponding column of the picture cost sheets. By this procedure the interlocking of cost records with the general accounts is automatic. The control account direct charges also controls the picture cost ledger, and the accuracy of the total cost of each picture is not only absolutely assured, but the correctness of the detailed expenses is proven, since the total of charges to all pictures contained in the picture cost ledger for any one classification of expense must agree with the total for that expense as shown by its general ledger sub-account.

When the total costs of any picture have been gathered, a credit should be passed to the direct charges account for the cost; and this amount should be charged to the account "completed pictures." Care should be taken to see that each secondary and sub-account is credited with the proper portion of this total expense as disclosed by the corresponding columns in the picture cost sheet. The picture cost sheet in the ledger should then be removed so as to maintain the balance between this ledger and the control account, direct charges, and be filed in a transfer binder for completed pictures. At the end of the year or when sales are made the account completed pictures would be credited with the cost price, as shown by the respective picture cost sheets, of pictures sold.

The account direct charges is then a control account of work in process and the account completed pictures is an inventory account of pictures on hand, supported by the detailed information found in the transfer binder for completed pictures.

As in most cost systems, the problem of distributing overhead equitably over product is here the most difficult one. A common practice in manufacturing cost systems is to lump all manufacturing costs other than direct charges under the general heading "indirect expenses" or "overhead," and to distribute all the many different items making up this total over product on one and the same basis. Many times these items are not properly distributable in the same proportion or on the same basis, and it is believed that a useful purpose will be served by distinguishing between different kinds of indirect or overhead expenses.

For the purposes of this article an attempt will be made to segregate these various costs into two classifications, since it is believed that greater accuracy will be obtained by so doing, inasmuch as they form two more or less distinct classes of expense, which are assignable to specific pictures on entirely different bases.

If the total cost of product is to be determined before the end of the year it is necessary to estimate in advance the aggregate amount of indirect expenses for the year. Now, one type of these costs can be accurately estimated in advance, while the other type cannot be estimated with any degree of accuracy at all. This is the chief point of distinction between the two, and the advantage to be gained by so distinguishing between them is that total costs can be determined for each picture to a high degree of accuracy within a short time after the picture is completed. By assembling in one group those expenses which vary from time to time and are applicable only to the period in which incurred, they may be distributed at short intervals, and the product will be charged with the actual amount of these expenses and not with an estimate or guess as to what they will or should be.

These expenses fall broadly into two classifications: first, those variable expenses which can not be assigned to any particular picture, but are more or less dependent upon the number of pictures produced, that is, the amount of production. These expenses will be termed here "indirect production costs."

The second classification consists of those expenses which are fixed and invariable to a great extent, and go on irrespective of the amount of production and, in fact, even if production activities entirely cease. These expenses will be termed "overhead charges" or "plant overhead." An outline of accounts for the first

class of expense mentioned, which is intended to be illustrative only and not comprehensive, follows:

Indirect production costs (control account)
- Salaries and wages not chargeable direct (secondary account)
  - Indirect labor (sub-account)
  - Wardrobe and property room salaries
  - Art department salaries
  - Supervision salaries
  - Unassigned staff and talent
- Employment department expense
- Wardrobe, property room and cutting room expense
- Still and art room expense
- Auto maintenance
- Materials and supplies
- Light and power (if not charged direct as above outlined)
- Indemnity insurance (if not charged direct)

Since these and similar expenses largely arise because of the pictures made within the period in which they are incurred and also vary with the amount of production, it is proper that the pictures made within this period should bear the expense. They can therefore be closed into picture costs at frequent intervals, say every four weeks or monthly. The basis of this distribution would depend upon the conditions obtaining at each particular studio, but it is believed that a distribution in proportion to the total direct charges would be as satisfactory as any other, if from the total of direct there were excluded the salaries of talent, which fluctuate violently, according to whether a highly paid star or stars or a more modestly salaried cast is employed. This basis for the distribution of indirect expense has been severely criticised as being illogical and arbitrary, but these expenses will usually be found to vary with and be largely dependent upon direct costs if salaries of cast are omitted.

At the end of each month the total for indirect expense as shown by its control account would be charged to direct costs, the charge going also to the sub-account entitled "proportion of indirect production expense and plant overhead," and also into the same column in the picture cost sheets for the pictures affected.

For purpose of analysis it can also be ascertained for each picture of what detailed expenses this total charge for proportion

of indirect expense is made up by taking the same percentage of the different expense sub-accounts as was taken of the total expense for that picture. Examples of the type of expense termed overhead charges, which would be classed under the group of accounts controlled by plant overhead, are:

Plant overhead	(control account)
Watchmen's and janitor's wages	(secondary account)
Rent	
Insurance	(fire—plant and equipment)
General property taxes	(on plant and equipment)
Repairs to plant and equipment	
Depreciation (plant and equipment)	
Proportion of administrative expenses	

These and similar expenses are more or less fixed, and it is possible to determine in advance to a fair degree of accuracy the exact sum to which they will amount in the course of a year or the average amount per annum over a period of years. Unlike the other type of expense, these expenses are not entirely applicable to the period in which they are incurred, but must be averaged over a longer period. Insurance is usually paid in advance for a year or several years; taxes are paid once or twice a year; repairs the cost of which is equally applicable to various periods will be made in one period; rent may be paid in advance. Any extraordinary expense incurred in one year may be averaged over several years by means of suspense acounts so as to maintain an equitable average. It is necessary, therefore, to know in advance to what these expenses will amount for any period, and this is easy of ascertainment in the case of these fixed charges.

In the case of expansions, additional ground rented or new buildings erected, the additional costs applicable to these extensions can also be determined in advance for the remainder of the year, which is all that is necessary, as product complete theretofore should not be charged with these additional costs.

It is true that the factors of depreciation and repairs on plant and equipment will vary to a certain extent with use, but in this industry at least this variation would be slight and the rate may be fixed so as to cover the normal average use.

Having ascertained the total of overhead charges for the ensuing year—and nearly every one of these expenses is exactly

ascertainable—it is a simple matter to allocate this total over the plant so as to determine a daily or hourly rental for each stage or lot, excluding, of course, the portion of these charges applicable to space occupied by administrative buildings, which will form a part of administrative expense.

When a picture is completed a charge at the determined hourly or daily rate will be made against it for the space or stages occupied. This charge will go into the control account for direct charges and also into the direct expense of sub-account, termed "proportion of indirect production costs and plant overhead." It will also go into the corresponding column in the picture cost sheet, which will then contain two items: one for proportion of indirect production costs and one for proportion of plant overhead. The contra credit should not go direct to plant overhead but into an intermediary account until the end of the year, for the reason that, unless all spaces or stages to which the total plant overhead was allocated are occupied constantly, which is improbable, not all of the plant overhead for the year will be distributed over product. This discrepancy between the amount distributed to pictures and the total of plant overhead may be handled by means of the supplemental rate advocated by A. Hamilton Church, in his discussion of the machine-rate plan of distributing indirect expense.

At the end of a three-months' period, for instance, so as not to delay the final determination of costs for too long a time, or even at the end of a month, the total amount charged to pictures for studio or stage rental, as shown by the credits to the intermediary account referred to, should be compared with the predetermined total of plant overhead applicable to that period. The difference can then be allocated to pictures made within the period as a supplemental charge for plant overhead, although this will have the effect of penalizing such pictures because of failure during that time properly to utilize all available space. Since this difference is an indication of waste in not keeping up production, it will serve a very useful purpose by showing this fact, and it should not perhaps be charged to particular pictures at all, but be closed out at the end of the year as a loss. Of course, if the organization is given over to the production of a certain picture so much that other production has to be neglected, it is proper that this picture should bear the loss occasioned thereby.

Administrative expenses should, of course, be kept under a separate classification. The proportion of administrative expense to be borne by the producing end of the business will need to be determined in each instance by the conditions obtaining. This proportion should form a part of plant overhead. In the case of a company which produces only and maintains no selling nor distributing organization, the whole of administrative expenses would be included in plant overhead.

Interest on the firm's own capital invested in plant and equipment has not been shown as a production cost because of the writer's opinion on that subject. It is also thought that interest paid on possible mortgages on plant should be considered as a deduction from income rather than as a manufacturing expense.

In closing, it might be pertinent to mention one or two income-tax problems that are probably somewhat peculiar to this industry.

It is understood that the internal revenue bureau in several instances has raised questions as to the tax liability of producers who have deducted each year as expenses the total costs of production without taking into consideration pictures on hand at the end of the year and pictures in process. It seems quite clear that income cannot be correctly reflected unless the inventory method of determining income is used. This basis was, undoubtedly, not used in many instances because of failure to keep accurate cost records.

A tax problem which frequently arises is that presented in the case of a producer who distributes his pictures on a state rights basis. The United States is divided into various territories for this purpose and a value is set upon each territory. That is, the total selling price of the picture is fixed, and each territory is assigned a certain percentage of this total. The producer then sells to exchanges in the different territories the right to exhibit or sell exhibiting rights in their districts. At the end of an accounting period a portion only of the total territory for a certain picture may have been sold. What is the inventory value of this picture? Although the legal title to the negative film still remains with the producer, its value is diminished as territorial rights are sold.

Inasmuch as the total amount to be realized is known with a

fair degree of certainty, it would seem just to assume that the same proportion of the cost of a picture remains on hand as the proportion of the amount yet to be realized is of the total selling price. If a material discrepancy later develops, an amended return may be filed. (Since the question of the value of foreign rights so complicates this question and the following one, it has been ignored here because of lack of space in which adequately to discuss it.)

Another problem frequently encountered occurs when a producer has contracted with a distributing company to produce one or a series of pictures for it. The distributor does not buy the picture outright but advances the producer, against the cost of a picture, a certain amount for the exclusive right to exploit and exhibit the picture for a period of years. Title remains with the producer, and any amounts realized on the distribution of the picture over and above the advance to cover cost of production, which usually involves a profit for the producer, is shared between them on an agreed basis. If at the end of an accounting period the producer has made and delivered to the distributor such a picture and received his advance thereon, should the picture be included in his inventory, and, if so, at what figure?

In view of the fact that the earnings from a picture in this case are a matter of conjecture and the producer does not know that he will ever receive anything more than the advance, it would seem permissible to consider the picture as disposed of, although it is not known what the position of internal revenue officers would be in such a case. In this case any excess of the advance over the cost of making the picture would be net income for the year of its receipt and any future earnings would be accounted for as net income when received.

The motion-picture field is too broad and conditions at different plants are too varied to give anything like a comprehensive outline of a cost system for it in an article of this length. What has been given here has been only an attempt at sketching a way of securing accurate costs under ordinary conditions. Many companies maintain their own laboratories, machine shops, garages, etc,. which would complicate the problems somewhat, but such cases could be handled in much the same manner as herein outlined by keeping separate cost of service rendered, as an outside business would do, eliminating, of course, the element of profit.

Inadmissible Assets

By Milton Rindler

In my income-tax experience, I have learned that the average business man does not even know what an inadmissible asset is—much less its effect on a corporation's excess-profits tax. If this element of invested capital were of little importance, this ignorance might be excused. But corporations make many investments, which have an important effect on their invested capital and consequently on their tax.

The government regulations define inadmissible assets as "stocks, bonds and other obligations (other than obligations of the United States) the dividends or interest from which are not included in computing net income." The law proceeds on the theory that if the income from an obligation is not taxed, the capital invested in that obligation should not be included as part of the corporation's invested capital. In other words, it would be double exemption first to exempt the interest on a state bond and then to exempt 8 per cent of the capital invested in that bond. The only exceptions are United States obligations, which may be included in invested capital.

Thus, stock in a domestic corporation, municipal and state bonds are inadmissible, while Liberty bonds are admissible.

A clear idea of what is and what is not an inadmissible asset may be gained from the following distinctions:

As the term "obligations of the United States" includes only direct obligations, bonds of Porto Rico are inadmissible. War finance bonds are not considered obligations of the United States and are inadmissible to the extent of a principal of $5,000.00, because only the interest on a principal of $5,000.00 of these bonds is exempt. The stock of federal reserve banks and federal farm loan bonds are inadmissible.

The law exempts from tax dividends from a corporation which is taxable upon its net income. Where dividends are received on stock of a foreign corporation, which derives income (no matter how small) from sources within the United States, and to that

extent is taxable under the law, the dividends so received are entirely exempt. Thus, the stock of a foreign corporation, which derives income from sources within the United States, is inadmissible, whereas stock of a foreign corporation, which derives no income from sources within the United States, is admissible.

The fact that no income is received from the obligation during the year does not affect its status as an inadmissible.

If part of the income from a stock or bond is exempt and another part, such as income from the sale of the obligation, is taxable, that proportion of the entire amount held of the obligation from which this income is derived which the taxable income bears to the total income is admissible. Take, for example, the following case:

A corporation owns $15,000 of A stock and $40,000 of B bonds at the beginning of the taxable year. It receives $750 in dividends on the A stock (Jan. 1-July 1—$500.00.—July 1-Dec. 31 —$250.00.) and $500 profit on the sale of $5,000 of the stock on July 1st of the taxable year. On the B bonds, interest of $2,000 is received during the year. The corporation pays during the year $1,000 in interest on money borrowed to purchase the bonds. The following schedule shows the amounts used in the computation and the results:

Obligation	*Principal*	*Total income*	*Non-taxable*	*Taxable*	*Inadmissible*	*Period*
A stock..	$15,000	$1,000	$500	$500	$7,500	Jan. 1-July 1
A stock..	10,000	250	250	.....	10,000	July 1-Dec. 31
B bonds..	40,000	2,000	2,000	1,000	20,000	Jan. 1-Dec. 31

As the profit on the sale of A stock is one-half of the total income, one-half of the stock is admissible from January 1st to July 1st, the date of the sale. From July 1st to the end of the year, the corporation holds $10,000. of inadmissibles. The law provides that interest paid on indebtedness incurred or continued to purchase obligations (other than obligations of the United States issued after September 24, 1917), the interest upon which is wholly exempt, is not deductible in computing net taxable income. The disallowance of the interest paid is the same in effect as taxing that much of the interest received on the obligation for which the indebtedness was incurred. Therefore, that proportion of the bonds for which the indebtedness was incurred

which the disallowed interest (i. e. taxable interest) bears to the total interest received on the bonds is admissible.

Under section 207 of the 1917 law and article 44 of regulations 41, borrowed money and inadmissibles could not be included in invested capital. It was found in the working out of the law that, if this provision were carried out, many businesses would have no invested capital. Furthermore, it was inequitable because the inadmissibles had been purchased partly or entirely with borrowed money. Assuming that they had been purchased with borrowed money, it was entirely wrong to eliminate both from invested capital. Being pressed for a quick solution to the problem, the treasury department passed a ruling giving the taxpayer the benefit of the doubt by assuming that all inadmissibles had been purchased with borrowed money. Only the excess of the inadmissibles over the total liabilities was deemed to have been acquired out of capital and for that reason had to be deducted in schedule C of the 1917 excess-profits blank in computing invested capital.

At first, this ruling was carried out by simply taking the amount of inadmissibles and the amount of liabilities at the beginning and end of the year, and using the average of each to determine the amount to be deducted. But it was found that in many cases, a monthly average of liabilities and inadmissibles was substantially different from a yearly average. Therefore, wherever there was a substantial difference, the monthly average was used.

In computing the amount of inadmissibles to be deducted, all liabilities were taken into consideration. Even though the liability could be directly connected with a specific admissible asset, such as money borrowed to purchase Liberty bonds, the liability was included in the computation. An exception arose, however, when, because of the limitation of interest under the 1917 law, a part of the borrowed money was allowed as invested capital. As soon as the borrowed money became invested capital, it could not be considered a liability to be included in the computation of inadmissibles. To consider it in the computation would be to contradict the theory upon which the deduction for inadmissibles in 1917 was based.

In the 1918 law, we find the provision for inadmissibles much more logical than under the 1917 law. The present law provides

that "there shall be deducted from invested capital as defined above a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year." The following hypothetical case will illustrate the treatment of inadmissibles under the 1918 law:

The AB Corporation's balance-sheet of Jan. 1, 1919

Assets			*Liabilities and Capital*	
Cash		$10,000	Accounts payable.........	$20,000
Accts. receivable...	$50,000		Notes payable............	10,000
Less reserve for bad debts......	1,000	49,000		
Notes receivable...	$5,000		Mortgage on plant........	10,000
Less notes rec. discounted	1,000	4,000		
			Capital stock.............	100,000
Inventory, mdse....		20,000	Surplus	43,000
Plant and mach....	$100,000			
Less reserve for depreciation ...	10,000	90,000		
Stocks, at cost.....		10,000		
		$183,000		$183,000

On May 1, 1919, inadmissibles costing $20,000 were purchased. On November 1, 1919, inadmissibles costing $10,000. were purchased. On December 31, 1919, the total admissible assets, as adjusted, amounted to $150,000.

In computing the percentage of inadmissibles, the assets must first be "adjusted in accordance with the provisions of the statute." Thus, for example, goodwill purchased with stock must be reduced to 25 per cent of the total capital stock outstanding on March 3, 1917, or at the beginning of the taxable year, depending upon the date when the goodwill was acquired.

As the reserve for bad debts is not allowable deduction in computing net taxable income, it should be regarded as part of surplus, leaving accounts receivable at the unadjusted value of $50,000.

"Notes receivable discounted" represents the contingent liability for notes which have been sold to the bank. These notes are

no longer assets of the corporation and are properly deducted as shown in the balance-sheet from the total notes receivable, leaving the net amount of $4,000.

"Plant and machinery" should be adjusted as shown in the balance-sheet by deducting the reserve for depreciation, leaving a net value of $90,000 to be used in the computation. If any part of the reserve for depreciation has been disallowed as a deduction, that part should not be deducted from the asset, but should be regarded as part of surplus. "Mortgage on plant" does not enter into the computation, as it does not reduce the value of the asset but simply represents the amount of capital borrowed to acquire the asset.

The assets at their adjusted values would then be as follows:

Cash	$10,000
Accounts receivable	50,000
Notes receivable	4,000
Inventory	20,000
Plant and machinery	90,000
Total admissible assets January 1, 1919	$174,000
Total admissible assets December 31, 1919	150,000
Total	$324,000
Average admissible assets	$162,000

The regulations provide that if at any time a substantial change has taken place either in the amount of inadmissible assets or in the total amount of admissible and inadmissible assets, the effect of such change shall be averaged exactly from the date on which it occurred. An example of such a change would be an issue of bonds or stock by a corporation during the year. The incoming cash would cause a substantial change in the amount of admissible assets. In our hypothetical case, there have been two substantial changes in the amount of inadmissibles during the year, which necessitate averaging from the date of each change. If the amount of merchandise inventory at the end of each month were known, and the books were fully posted each month, the amounts of admissible and inadmissible assets could be averaged monthly. In this case, however, only a yearly average of admissibles can be taken.

The inadmissibles would be averaged as follows:

Date of change	*Amount*	*Number of days*	*Fraction of year*	*Average amount*
Jan. 1, 1919.........	$10,000	365	......	$10,000.00
May 1, 1919.........	20,000	245	49/73	13,424.66
Nov. 1, 1919.........	10,000	61	61/365	1,671.23
Average inadmissibles				$25,095.89

Average admissibles	$162,000.00
Average inadmissibles	25,095.89
Average total admissible and inadmissible assets......	$187,095.89

Percentage of average inadmissibles to average of total assets equals 13.4 per cent.

This percentage of the invested capital gives the amount to be deducted, leaving the net invested capital.

The Journal of Accountancy

Published monthly for the American Institute of Accountants by
The Ronald Press Company, 20 Vesey Street, New York, N. Y.
Thomas Conyngton, president; L. G. Henderson, secretary;
Hugh R. Conyngton, treasurer

A. P. RICHARDSON Editor

EDITORIAL

Regional Meetings

The regional meeting of the American Institute of Accountants held in Chicago, November 19th, was, we honestly believe, an epoch-making event in the history of accountancy in the United States. It was not the first step in the path of progress—the tri-state meetings of Delaware, Maryland and Virginia accountants led the way several years ago—but it was a second step, and one that brought us considerably onward.

In a country so large as this, it is always difficult to secure unity of thought, manner, aim and action. It is not possible to assemble the entire membership of a national organization such as the institute, and there will always be a proportion, generally large, of the membership whose attendance is prevented by distance or other obstacle. There will also be a proportion of the membership which will feel itself out of touch with the affairs of the organization and will be inclined to a sense of isolation because of inability to be present at the annual meetings of the national body. But the justification for such sentiments will be reduced to an inconsiderable minimum if the institute goes to members who cannot or will not come to the institute.

It would, of course, be out of the question to hold satisfactory regional meetings in enough places to bring every member within an hour's travel of the point of meeting, but if it can be arranged—and ultimately we believe it can—that at least once in every year there shall be a meeting of accountants under the ægis of the

institute at a point within twelve hours' travel of every member, the old complaint that the institute and its meetings are far removed from many of the members will be almost completely refuted.

The meeting at Chicago, for example, which was attended by about 300 accountants, did not draw upon any territory more than a night's journey from the place of meeting. A similar meeting is to be held in Boston, December 8th, at which representatives of all New England states are expected to be present. Here again the place of meeting is within twelve hours' journey of every accountant, and within a shorter journey of the great majority of accountants in New England.

It is not asking or expecting too much of a practising accountant that he shall attend professional gatherings which make no greater demand upon his time or resources than a night's journey each way and the traveling expenses involved.

A meeting is to be held next June in Norfolk, Virginia, which will draw upon the south-eastern states. Other regional meetings are being discussed and will probably be held in other parts of the country when the success of the meetings of Chicago and Boston becomes generally known.

There are so many advantages to be gained by the meeting together of accountants and the discussing of vexed questions, that it seems unnecessary to mention them.

By getting together, exchanging ideas, meeting personally and hearing of the problems which confront one's confréres, one obtains a breadth of view and of sympathy which can never be acquired by the man who remains confined within the limits of his own practice and immediate environment.

At the meetings which are to be held, it has been arranged that everyone engaged or directly interested in public accounting and residing or practising within the region covered by the meeting shall receive an invitation to attend. At Chicago fully one-half the accountants in attendance at the meeting were not connected with the American Institute of Accountants. They were invited by representatives of the institute, were accorded every privilege and courtesy, and received invitations to seek membership in the institute if they were qualified. The direct result will be a considerable accession to the membership.

If this were the sole result of the meeting in Chicago, it would be well worth while, but there will certainly be other results.

The old idea that the institute was an exclusive organization, sufficient unto itself, will be dispelled as accountants generally find that they are welcome at the regional meetings and are desired as members if they can conform to the constitutional requirements.

The ideals of ethical procedure adopted by the institute and observed by most of its members can be gradually disseminated throughout the entire accounting profession by means of such meetings.

For several years there has been a feeling that something should be done to bring the institute into closer touch with the profession in some of the sections of the country most remote from such centers as New York and Chicago. The fact that the institute's operating office is in New York has been the subject of criticism. The constitutional provision that two annual meetings out of three shall be held in the District of Columbia has also raised a certain amount of objection in outlying districts. With these facts in mind, the institute has considered and is considering the formation of chapters wherever such organization may be desirable. That matter has not yet reached a definite point of development. A new committee was appointed last September and is now working on a general plan of chapter organization and control. In the meantime regional meetings are doing much to answer the attacks which have been made by those who are placed far from the centers of activity.

Perhaps the regional meeting is a half-way point between institute and chapter. At any rate, it is an altogether desirable development. At Chicago there was not a single criticism of the regional idea. Indeed, it is difficult to imagine a valid criticism that could have been offered.

Income-tax Department

Edited by Stephen G. Rusk

During the month that has elapsed since the last issue of The Journal of Accountancy five treasury decisions have been made, all of which are worthy of careful consideration.

At a time like this, when there is considerable agitation for the repeal of the excess-profits-tax law; for the deferring of payment of the December 15th instalment of federal tax, and for a new law to take the place of the excess-profits-tax law, it behooves accountants to remember that even if the excess-profits-tax law should be repealed in 1921, the old law will apply to the years 1909 to 1920, inclusive, and therefore the decisions handed down by the various authorities will have important bearing upon every enterprise involved thereby for many years to come.

The decisions that are published in The Journal of Accountancy this month cover a varied field and all are interesting.

Number 3076 amends those articles appertaining to depletion of timber and promulgates two new articles (236 and 237), in which are laid down rules for "aggregating timber and land values for purposes of valuation" and the accounting that is required by the department in cases of depletion of timber.

The methods of valuation, nature of proof thereof, method of determination of unit value and the application of said unit value in determination of amount of depletion are set forth in clear, understandable terms in this decision.

It is doubtful, however, whether there are many concerns engaged in lumbering operations whose accounting history is complete enough to make it possible to comply with the requirements of the department. Those who revise their books and records to fit them to show the information required will have made at least that part of their business appertaining to valuation and depletion up to date. Those whose records have been kept in a manner to show the facts required by the department will know that their accounts and records are comprehensive and in line with the best accounting practice. Those whose records will not show these data will do well to bring their appraisals, accounts and other records into line.

District Judge Knox, of the district court of the United States for the southern district of New York, handed down a decision in which is contained interesting information of that which constitutes gross income of "every insurance company by whatever name they are called." He concludes that premium deposits made in advance by members of mutual insurance companies to cover estimated losses and expenses, so long as the payment thereof constitutes the consideration for contract of insurance, constitutes gross income.

This decision will make it necessary for this kind of insurance company

to estimate its losses and expenses with greater accuracy if it is to avoid paying a tax on a transaction that has been generally considered to be one for mutual protection and not for profit.

Treasury decision 3080 relates to excess-profits taxation of a partnership under the law of 1916-17, and, while its application is perhaps to the specific case of which it treats, it is also indicative of what must be present in a partnership return to segregate isolated transactions of the individual partners from those that may be said to constitute a "single trade or business."

Article 42 of regulations 45 is amended by treasury decision 3082, more clearly to define what constitute sales of personal property on the instalment plan.

Treasury decision 3089 has to do with depletion allowance in case of discovery of a valuable deposit of mineral, oil or gas.

The provisions of this decision are such as to define the rights to such value, for depletion purposes, as between lessor and lessee. It provides that the value so discovered be apportioned between lessor and lessee.

TREASURY RULINGS

(T. D. 3076, October 5, 1920)

Income tax. Depletion of timber

Articles 228, 229, 230, 231, 233, 234 and 235 of regulations No. 45 amended and articles 236 and 237 inserted

Articles 228, 229, 230, 231, 233, 234 and 235 of regulations No. 45 are hereby amended and articles 236 and 237 are promulgated, as follows:

ART. 228. *Capital recoverable through depletion allowance in the case of timber.*—In general, the capital remaining in any year recoverable through depletion allowances may be determined as indicated in articles 202 and 203. In the case of leases the apportionment of deductions between the lessor and lessee will be made as specified in article 204. The cost of timber properties shall be determined in accordance with the principles indicated in article 205. For method of determining fair market value and quantity of timber, see articles 234, 235 and 236. For depletion purposes the cost of the timber shall not include any part of the cost of the land.

ART. 229. *Computation of allowance for depletion of timber for given year.*—The allowance for depletion of timber in any taxable year shall be based upon the number of units of timber felled during the year and the unit value of the timber in the timber account or accounts pertaining to the timber cut. The unit value of the timber for a given timber account in a given year shall be the quotient obtained by dividing (*a*) the total number of units of timber on hand in the given account at the beginning of the year plus the number of units acquired during the year plus (or minus) the number of units required to be added (or deducted) by way of correcting the estimate of the number of units remaining available in the account into (*b*) the total fair market value as of March 1, 1913, and (or) cost of the timber on hand at the beginning of the year, plus the cost of the number of units acquired during the year, plus proper additions to capital (see art. 231). The amount of the deduction for depletion in any taxable year with respect to a given timber account shall be the product of (*a*) the number of units of timber cut from the given account during the year multiplied by (*b*) the unit value of the timber for the given account for

the year. Those taxpayers who keep their accounts on a monthly basis may, at their option, keep their depletion accounts on a monthly basis, in which case the amount deductible on account of depletion for a given month will be determined in the manner outlined above for a given year. The total amount of the deduction for depletion in any taxable year shall be the sum of the amounts deductible for the several timber accounts. For description of timber accounts see articles 235 and 236.

The depletion of timber takes place at the time the timber is felled. Since, however, it is not ordinarily practicable to determine the quantity of timber immediately after felling, depletion for purposes of accounting will be treated as taking place at the time when, in the process of exploitation, the quantity of timber is first definitely determined.

ART. 230. *Revaluation of timber not allowed.*—In the case of timber acquired prior to March 1, 1913, the fair market value as of that date shall, when determined and approved by the commissioner, be the basis for determining the depletion deduction for each year during the continuance of the ownership under which the fair market value of the timber was fixed, and during such ownership there shall be no redetermination of the fair market value of the timber for such purpose. However, the unit market (or cost) value of the timber will subsequently be changed if from any cause such unit market (or cost) value, if continued as a basis of depletion, shall upon evidence satisfactory to the commissioner be found inadequate or excessive for the extinguishment of the cost, or fair market value as of March 1, 1913, of the timber.

ART. 231. *Charges to capital and to expenses in the case of timber.*—In the case of a timber property held for future operation by an owner having no substantial income from the property or from other sources, all expenditures for administration, protection, and other carrying charges prior to production on a normal basis shall be charged to capital account; after such a property is on a normal production basis such expenditures shall be treated as current operating expenses. In case a taxpayer, who has a substantial income from other sources, owns a timber property which is not yet on a normal production basis, he may, at his option, charge such expenditures with respect to such timber property to capital, or treat them as current operating expenses, but whichever system is adopted must be followed until permission to change to the other system is secured from the commissioner. In the case of timber operations all expenditures prior to production for plants, improvements and equipment, and thereafter all major items of plant and equipment, shall be charged to capital account for purposes of depreciation. After a timber operation has been developed and equipped and has reached its normal output capacity, the cost of additional minor items of equipment and the cost of replacement of minor items of worn-out and discarded plant and equipment may be charged to current operating expenses, unless the taxpayer elects to write off such expenditures through charges for depreciation; however, the method adopted must be followed consistently from year to year.

ART. 232. Not changed.

ART. 233. *Information to be furnished by taxpayer claiming depletion of timber.*—To the income-tax return of the taxpayer claiming a deduction for depletion or depreciation or both there shall be attached a map and statement (form T-Timber) for the taxable year covered by the income-tax return. Form T-Timber requires the following: (*a*) map showing timber and land acquired, timber cut, and timber and land sold; (*b*) description of, cost of, and terms of purchase or lease of, timber and land acquired; (*c*) proof of profit or loss from sale of capital assets; (*d*) description of timber with respect to which claim for loss, if any, is made; (*e*) record of timber cut; (*f*) changes in each timber account as the result of purchase,

sale, cutting, re-estimate, or loss; (*g*) changes in physical property accounts as the result of additions to or deductions from capital and depreciation; (*h*) operation data with respect to raw and finished materials handled and inventoried; (*i*) unit production costs, and (*j*) any other data which will be helpful in determining the reasonableness of the depletion and (or) depreciation deductions claimed in the return. Similar information is required for certain years prior to the 1919 taxable year from those taxpayers who have not already furnished it. The specific nature of the information required for the earlier years is given in detail in form T-general forest industries questionnaire for the years prior to 1919.

ART. 234. *Determination of fair market value of timber.*—Where the fair market value of the property at a specified date, in lieu of the cost thereof, is the basis for depletion and depreciation deductions, such value shall be determined, subject to approval or revision by the commissioner upon audit, by the owner of the property in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, in methods of exploitation, in degree of utilization, etc. The value sought will be the selling price, assuming a transfer between a willing seller and a willing buyer as of the particuar date. Such factors as the following will be given due consideration: (*a*) character and quality of the timber as determined by species, age, size, condition, etc.; (*b*) the quantity of timber per acre, the total quantity under consideration, and the location of the timber in question with reference to other timber; (*c*) accessibility of the timber (location with reference to distance from a common carrier, the topography and other features of the ground upon which the timber stands and over which it must be transported in process of exploitation, the probable cost of exploitation, and the climate and the state of industrial development of the locality), and (*d*) the freight rates by common carrier to important markets. The timber in question will be valued on its own merits and not on the basis of general averages for regions; however, the value placed upon it, taking into consideration such factors as those mentioned above, will be consistent with that of the other timber in the region. The commissioner will give due weight and consideration to any and all facts and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, the margin between the cost of production and the price realized for timber products, market value of stock or shares, royalties and rentals, value fixed by the owner for the purpose of the capital stock tax, valuation for local or state taxation, partnership accountings, records of litigation in which the value of the property has been involved, the amount at which the property may have been inventoried and (or) appraised in probate or similar proceedings, disinterested appraisals by approved methods, and other factors. For depletion purposes the fair market value at a specified date shall not include any part of the value of the land.

ART. 235. *Determination of quantity of timber.*—Each taxpayer claiming or expecting to claim a deduction for depletion is required to estimate with respect to each separate timber account the total units (feet board-measure log scale, cords or other units) of timber reasonably known or on good evidence believed to have existed on the ground on March 1, 1913, or on the date of acquisition of the property, as the case may be. This estimate shall state as nearly as possible the number of units which would have been found present by a careful estimate made on the specified date with the object of determining 100% of the quantity of timber which the area would have produced on that date if all of the merchantable timber had been cut and utilized in accordance with the standards of utilization prevailing in that region at that time. If subsequently during the ownership of the taxpayer

making the return, as the net result of the growth of the timber, of changes in standards of utilization, of losses not otherwise accounted for, of abandonment of timber, and (or) of errors in the original estimates, there are found to remain on the ground, available for utilization, more or less units of timber than remain in the timber account or accounts, a new estimate of the recoverable units of timber (but not of the cost or the fair market value at a specified date) shall be made, and, when made, shall thereafter constitute a basis for depletion.

ART. 236. *Aggregate timber and land for purposes of valuation and accounting.*—With a view to logical and reasonable valuation of timber, the taxpayer shall include his timber in one or more accounts. In general, each such account shall include all of the taxpayer's timber which is located in one "block," a block being an operation unit which includes all of the taxpayer's timber which would logically go to a single given point of manufacture. In those cases in which the point of manufacture is at a considerable distance, or in which the logs or other products will probably be sold in a log or other market, the block may be a logging unit which includes all of the taxpayer's timber which would logically be removed by a single logging development. In exceptional cases, provided there are good and substantial reasons, and subject to approval or revision by the commissioner on audit, the taxpayer may divide the timber in a given block into two or more accounts, e. g., timber owned on February 28, 1913, and that purchased subsequently may be kept in separate accounts, or timber owned on February 28, 1913, and the timber purchased since that date in several distinct transactions may be kept in several distinct accounts, or individual tree species or groups of tree species may be carried in distinct accounts, or special timber products may be carried in distinct accounts, or blocks may be divided into two or more accounts based on the character of the timber and (or) its accessibility, or scattered tracts may be included in separate accounts. When such a division is made, a proper portion of the total value or cost, as the case may be, shall be allocated to each account.

The timber accounts mentioned in the preceding paragraph shall not include any part of the value or cost, as the case may be, of the land. In a manner similar to that prescribed in the foregoing part of this article the land in a given "block" may be carried in a single land account or may be divided into two or more accounts on the basis of its character and (or) accessibility. When such a division is made, a proper portion of the total value or cost, as the case may be, will be allocated to each account.

The total value or total cost, as the case may be, of land and timber shall be equitably allocated to the timber and land accounts, respectively.

Each of the several land and timber accounts carried on the books of the taxpayer shall be definitely described as to their location on the ground either by maps or by legal descriptions.

For good and substantial reasons to be approved by the commissioner, or as required by the commissioner, the timber or the land accounts may be readjusted by dividing individual accounts by combining two or more accounts, or by dividing and recombining accounts.

ART. 237. *Timber depletion and depreciation accounts on books.*—Every taxpayer claiming, or expecting to claim, a deduction for depletion and (or) depreciation of timber property (including plants, improvements and equipment used in connection therewith), shall keep accurate ledger accounts in which shall be charged the fair market value as of March 1, 1913, or the cost, as the case may be, of (*a*) the property, and (*b*) the plants, improvements and equipment, together with such amounts subsequently expended for the administration, protection, and other carrying charges, or development of the property or additions to plant and equipment as are not chargeable to current operating expenses. (See arts. 231

and 236.) In such accounts there shall be set up separately the quantity of timber, the quantity of land, and the quantity of other resources, if any, and a proper part of the total value or cost shall be allocated to each. (See art. 236.) These accounts shall be credited with the amount of the depreciation and depletion deductions claimed and allowed each year, or the amount of the depreciation and depletion shall be credited to depletion and depreciation reserve accounts, to the end that when the sum of the credits for depletion and depreciation equals the value or cost of the property, plus the amount added thereto for administration, protection, and other carrying charges, or development or for additional plant and equipment, less salvage value of the physical property, no further deduction for depletion and depreciation will be allowed.

(T. D. 3078, October 13, 1920)

Income tax—Decision of court

Corporation excise and income taxes—Acts of August 5, 1909, and October 3, 1913

1. *Gross Income of Insurance Companies—Premium Receipts.*

The premium receipts of "every insurance company" by whatever name they are called are, unless specifically exempted by the terms of the taxing statutes in question, a part of such company's gross income.

2. *Same—Premium Deposits.*

Premium deposits made in advance by members of a mutual insurance company to cover estimated losses and expenses are, so long as the payment thereof constitutes the consideration for contract of insurance, insurance premiums constituting gross income of the company.

3. *Same—Interest on Bank Balances and Profits from Investment of Premium Deposits.*

Moneys received by way of interest upon bank balances and from investment of such portion of premium deposits as are not currently required for the payment of losses and expenses are profits earned by an insurance company subject to tax.

4. *Mutual Fire Insurance Companies—Corporation Coming Within Meaning of.*

A corporation, organized to insure its members, limited to jewelers and dealers in goods ordinarily in the jewelry trade against loss or damage by fire, theft, barraty, embezzlement and transportation, which requires each member to deposit in advance a definite sum sufficient to cover estimated losses and expenses for the ensuing year, the balance of such deposits being returned to members, is a mutual fire insurance company and subject to the taxes imposed by the acts of August 5, 1909, and October 3, 1913.

The appended decision, dated July 19, 1920, of the United States district court for the southern district of New York, on the cases of *Jewelers Safety Fund Society v. Lowe, collector,* and *Jewelers Safety Fund Society v. Anderson, collector,* is published for the information of internal revenue officers and others concerned.

District Court of the United States for the Southern District of New York

Jewelers Safety Fund Society, plaintiff, v. John Z. Lowe, Jr., collector of internal revenue, defendant, and Jewelers Safety Fund Society, plaintiff, v. Charles W. Anderson, collector of internal revenue, defendant.

Upon demurrer to the complaint on the ground that it does not state facts sufficient to constitute a cause of action

Knox, District Judge: The premium receipts of "every insurance company" are, unless specifically exempted by the terms of the taxing statutes

in question, a part of such company's gross income, and, as such, are to be accounted for. (*Penn Mutual Life Ins. Co. v. Lederer,* No. 499, supreme court of the United States, decided April 19, 1920.)

It makes no difference by what name the premiums are called so long as the payment thereof constitutes the consideration for the insurance contract. Now, that is precisely the function performed by the co-called deposits made with the plaintiff company by the persons who enjoy the protection of its policies. That such deposits are in excess of the probable cost of, and loss incident to, the risk of the insurance written by the company does not change the character of the payments. In other words, the deposits are at all times while in the possession of the company subject to application to its expenses and losses. That the entire sum may not be required for such purposes is but an incident of the nature of the company and its good fortune in not being subjected to unusual losses and the consequent depletion of the funds applicable to the payment thereof. If there were any doubt as to the nature of the deposit it should be resolved against the company by reason of the provisions of section G, subdivision (*b*), of the act of October 3, 1913. There, deposits, of the same nature as the deposits here made, are designed "premium deposits." See also *Union Ins. Co. v. Hoge* (21 How., 35).

I think it altogether clear that the plaintiff is not within any of the classes of companies and organizations which, under the taxing acts of 1909 and 1913, enjoy entire freedom from liability to taxation. Unless, therefore, it may be held that under some portion of the statute of 1913 the plaintiff is the beneficiary of a partial immunity from taxation, it must be liable therefor upon its entire net income to be ascertained as the act declares. Taxation upon such basis would, however, considering the nature of plaintiff's organization and its method of doing business (viz, the maintenance on hand of a large margin between estimated *probable* losses and those reasonably *possible*), result in a series of inconsistent and inequitable tax assessments, and in making exceptions as to the method of determining net income as to certain mutual insurance companies the congress proceeded with its legislation along a very definite and logical line. We observe as a result the proviso contained in subdivision (*b*) of section G.

Passing, now, to other sources of income possessed by the plaintiff, it is found that it receives money by way of interest upon bank deposits and from the investment of such portion of its premium deposits as are not currently required for losses and expenses. The yield thus accruing to the plaintiff ultimately reduces the cost of insurance to those holding policies. In other words, the company earns a profit by means of its management and control of the premium deposits. Such profit is subject to tax under the authority of *Penn Mutual Insurance Co. v. Lederer,* supra. Furthermore, if the plaintiff is a mutual fire insurance company under subdivision (*b*) of the 1913 act, the yield, from bank balances and investments made, by the terms of such subdivision may be said to be specifically subject to tax.

The plaintiff was chartered by a special act of the New York state legislature. Section 2 of the act of incorporation authorizes the society to insure manufacturers or importers of, and wholesale or retail dealers in, watches, * * * jewelry, diamonds, and similar articles against loss or damage thereto by any and all risks of fire, theft, barratry and embezzlement, and any and all risks of transportation by land or water. With this delegation of power I fail to see why the plaintiff is any less a mutual fire insurance company because of the fact that in addition to writing insurance upon the mutual plan against fire risks, it insures, likewise on the mutual plan, against the risk of theft, embezzlement, transportation and other hazards.

It may be true, as suggested by counsel for plaintiff, that this society would not be described as a fire insurance corporation under the general

insurance law of the state; but I believe it may fairly be said that were the insured of this society not limited to jewelers and those dealing in goods ordinarily carried in the jewelry trade, the company might very properly be so described. Certainly it is no more inconsistent to call this company a mutual fire insurance corporation than it would be (as does the New York statute) to so call a company which, upon the mutual plan, insures not only against risks by fire but also against risks of lightning, windstorm, tornado, cyclone, earthquake, hail, frost or snow.

I suppose that, generally speaking, life, fire and marine insurance are the most distinctive branches of indemnity underwriting. Practically all of such companies now insure against other hazards than death, fire and marine disaster, but the distinctive character of such companies is not altogether obliterated for that reason. I consequently am of opinion that when in 1913 congress made a special proviso with respect to mutual fire insurance companies, its intent and purpose was quite sufficient to include the plaintiff company within such designation.

Reaching, as I do, the aforementioned conclusion, it follows that after taking advantage of all deductions from gross income which the law permits the plaintiff, there still remained to the plaintiff for the years 1912, 1913, 1914 and 1915, under the statutes then in force, an amount of gross income subject to taxation.

The demurrer to each of the complaints will be sustained.

(T. D. 3080, October 19, 1920)

Income tax—Excess profits taxes—Decision of court

1. *Partnership—Single Trade or Business.*

In determining liability under section 209 of the act of October 3, 1917, income derived from a single timber-land deal by a partnership, whose principal business is dealing in lumber, cannot, by reason of section 201 of the act, be considered and treated separate and apart from other partnership income or profits.

2. *"Invested Capital" Defined.*

The term "invested capital," as used in section 209 of the act of October 3, 1917, includes all working capital consisting of money or property employed in the business or for its benefit, and furnished or paid in by one or more of the partners.

3. *Partnership—Rate of Assessment Where Having Invested Capital.*

Where, during the year 1917, a partnership had invested capital, as above defined, more than nominal in amount, excess profits taxes upon its income could not be assessed at the lower rate provided by section 209 of the act of October 3, 1917.

4. *Partnership—Objection to Method of Determining Invested Capital.*

A partnership which had invested capital more than nominal in amount cannot complain of regulations promulgated or of the method employed in determining the amount of such capital, where the arbitrary or supposititious invested capital fixed upon was larger in amount than the invested capital actually possessed and employed, and the taxes imposed were correspondingly diminished.

5. *Partnership—Brokers.*

Members of a partnership who are paid neither a salary nor commissions for their services, but who buy and sell lumber and undertake and assume all the risks and enjoy all the benefits of a merchandising business, employing a large amount of capital, are not brokers.

6. *Partnership—Property Pledged as Collateral Security as Part of Invested Capital.*

Property of member of partnership deposited with bank and pledged as collateral security for the repayment of a loan by or for the benefit of the partnership in pursuance of the articles of partnership is part of the invested capital of such partnership.

The appended decision of the district court of the United States for the western district of Michigan, southern division, in the case of *Cartier-Holland Lumber Co., a partnership, v. Doyle, collector,* rendered August 7, 1920, is published not as a ruling but for the information of internal revenue officers and others concerned.

District Court of the United States, Western District of Michigan, Southern Division

Charles E. Cartier and Edward M. Holland, copartners, doing business under the firm name and style of Cartier-Holland Lumber Co., plaintiffs, v. Emanuel J. Doyle, collector, defendant.

Sessions, District Judge: Cartier-Holland Lumber Co. is a partnership, composed of Charles E. Cartier and Edward M. Holland, engaged in the business of buying, selling and dealing in timber, lumber and other forest products. The net income or profits of the firm during the taxable year 1917 amounted to $47,018. Of this sum, $20,353 resulted from an isolated sale of timbered land and the balance from the regular or customary lumber business of the partnership. The company has never owned any lands, timber, plant, mill or yard, and has never done any manufacturing or carried any stock of manufactured lumber. Its principal business consisted of buying lumber from manufacturers and reselling the same to its own customers. The business was conducted by the partners personally, with the assistance of a small clerical office force, one bookkeeper and two stenographers. Since its organization in 1912, the firm has at all times been a heavy borrower of money. According to its books, on January 1, 1917, the company's indebtedness to banks for borrowed money was the sum of $36,300, and its other indebtedness, presumably for lumber purchased, amounted to $12,309.22, making a total indebtedness of $48,609.22; its accounts and bills receivable, probably representing lumber sold, aggregated $39,281.72, and its other assets, including petty cash, office furniture, insurance paid, and cash in bank, amounted to the sum of $2,108.65, making a total of assets of $41,390.37. In other words, at the beginning of the taxable year, the liabilities of the firm exceeded its assets by the sum of $7,218.85. The account of each member of the firm was then several thousand dollars overdrawn. At the end of the year 1917, the firm assets exceeded its liabilities by nearly $14,000, which consisted entirely of profits made during the taxable year.

Plaintiff's articles of agreement of copartnership contained the following provision:

The paid-in capital of the partnership is to be thirty thousand dollars ($30,000), all or any portion of which amount is to be furnished to the partnership by above named Charles E. Cartier, as the requirements of the partnership appear, and upon the note or notes of such partnership; such note or notes not to be made transferable nor made items of record. Such notes are to be paid at the earliest practicable opportunity out of the net earnings of the partnership business, and to bear legal rate of interest.

For a time, in carrying out this provision of the partnership agreement, plaintiff Cartier borrowed money from the banks upon his own note secured by collateral and furnished the same to the company. Later, and probably before January 1, 1917, the agreement was modified and working capital

was obtained by borrowing money from banks upon firm notes, indorsed by both members of the firm and secured by collateral furnished by Cartier, the property so pledged as collateral security in all cases and at all times being of greater value than the face of the notes. This method was pursued during the entire year 1917.

Plaintiffs, as copartners, made due return of net income of $47,018 for the year 1917, and voluntarily paid an excess profits tax, computed at 8%, in accordance with the provisions of section 209 of Title II of the act of October 3, 1917, and amounting to $3,761.44. Apparently, their right to a deduction of $6,000 from the income before computing the tax was inadvertently overlooked. Thereafter the commissioner of internal revenue, claiming that plaintiffs were not entitled to the benefit of the provisions of section 209 of the act of October 3, 1917, but were taxable under the provisions of sections 201 and 210 of that act, assessed against them an additional excess profits tax for 1917 amounting to $9,027.46. Plaintiffs paid the additional tax under protest and have brought this suit for its recovery.

The conclusions reached upon questions of law involved in this case may be thus summarized:

1. Plaintiff's contention that, in the assessment of excess profits taxes, the income derived from the single timber-land deal, amounting to the sum of $20,353, must be considered and treated by itself and separate and apart from other partnership income or profits is negatived, in express terms, by the statute here under consideration:

For the purpose of this title every corporation or partnership not exempt under the provisions of this section shall be deemed to be engaged in business, and all the trades and business in which it is engaged shall be treated as a single trade or business, and all its income from whatever source shall be deemed to be received from such trade or business.

(Confessedly the company's principal business was dealing in lumber, and under this statute its entire income must be attributed to that business.)

2. If during the year 1917 Cartier-Holland Lumber Company had invested capital, within the purview and meaning of that term as employed in the statute, more than nominal in amount, excess profits taxes upon its income could not be assessed under the provisions of section 209 of the statute, and if the amount of such invested capital could not be satisfactorily determined, excess profits taxes must have been assessed under sections 201 and 210 in accordance with proper regulations prescribed by the commissioner of internal revenue. If the lumber company had invested capital more than nominal in amount, plaintiffs are not in a position to complain of the regulations promulgated or of the method employed in determining the amount of the firm's invested capital which forms the basis of the computation of the taxes, because under the undisputed evidence the arbitrary or suppositious invested capital fixed upon was larger in amount than the invested capital actually possessed and employed, and the taxes imposed were correspondingly diminished. These taxes are assessed upon percentages of income to invested capital. The larger the capital the smaller the percentage and resulting tax.

3. Plaintiffs are not brokers within any accepted definition of that term. They are paid neither a salary nor commissions for their services. They buy and sell lumber and undertake and assume all the risks and enjoy all the benefits of a merchandising business. They employ a large amount of capital; their income is dependent upon their personal services and efforts only in the same way and to the same extent that the farmer who works his own farm or the merchant who conducts his own store derives his income from his individual endeavors.

4. The rights of these parties cannot be made to depend upon nonstatutory classifications, regulations or definitions. The statute applies to

all trades and businesses without regard to their class or character. While in doubtful cases departmental regulations may be an aid in construction and interpretation, they can neither add to nor substract from plain congressional enactments. In this instance differences in the meaning of the terms "invested capital" and "capital" are wholly immaterial. If Cartier-Holland Lumber Company had any invested capital, it was substantial and not merely nominal, and plaintiffs must fail. On the other hand, if the company had no invested capital, plaintiffs are entitled to recover, regardless of the amount of its borrowed or other non-invested capital.

That the partnership was doing business upon borrowed money is beyond dispute, and that invested capital does not include borrowed money is settled by the express terms of the statute, but it by no means follows that plaintiffs are right in their contentions. The term "invested capital" as here used includes all working capital, consisting of money or property employed in the business or for its benefit and furnished or "paid in" by one or more of the partners. Applying this test, it is clear that this partnership had invested capital within the purview and meaning of the statute. In the determination of this question, money borrowed from banks or individuals other than members of the firm and solely upon the credit of the firm must be excluded and may not be considered; and, for the purpose of this decision, it is unnecessary to determine whether, as claimed by counsel for defendant, money borrowed upon the notes of the firm, indorsed by the individual partners, and largely, if not wholly, upon the credit of the latter, is to be deemed invested capital of the partnership. If the original partnership agreement had been carried out and performed, it would not be claimed that the moneys paid in and furnished by plaintiff Cartier, in accordance with its terms, would not constitute invested capital of the firm, without regard to the manner in which or the source from which such moneys were obtained by him. The method or plan adopted and used in 1917 was a change in form rather than in substance. The evidence shows conclusively that for every dollar of money borrowed from the bank property of one of the members of this firm exceeding in value the amount of the loans was deposited with the bank and pledged as collateral security for the repayment of such borrowed money. The property so furnished and pledged became a part of the working capital, and was used and employed in the business of the company to the same extent as if it had been paid directly into the firm treasury.

Judgment will be entered for defendant, with costs of suit to be taxed.

(T. D. 3082, October 20, 1920)

Income tax

Gross income defined—Inclusions—Article 42, regulations No. 45, amended

Article 42 of regulations No. 45 is hereby amended to read as follows:

ART. 42. *Sale of personal property on instalment plan.*—Dealers in personal property ordinarily sell either for cash or on the personal credit of the buyer or on the instalment plan. Occasionally a fourth type of sale is met with, in which the buyer makes an initial payment of such a substantial nature (for example, a payment of more than 25%) that the sale, though involving deferred payments, is not one on the instalment plan. In sales on personal credit, and in the substantial payment type just mentioned, obligations of purchasers are to be regarded as the equivalent of cash, but a different rule applies to sales on the instalment plan. Dealers in personal property who sell on the instalment plan usually adopt one of four ways of protecting themselves in case of default: (*a*) through an agreement that title is to remain in the seller until the buyer has completely performed his part of the transaction; (*b*) by a form of contract in which title is con-

veyed to the purchaser immediately, but subject to a lien for the unpaid portion of the purchase price; (*c*) by a present transfer of title to the purchaser, who at the same time executes a reconveyance in the form of a chattel mortgage to the seller; or (*d*) by conveyance to a trustee pending performance of the contract and subject to its provisions. The general purpose and effect being the same in all of these plans, it is desirable that a uniformly applicable rule be established. The rule prescribed is that in the sale or contract for sale of personal property on the instalment plan, whether or not title remains in the vendor until the property is fully paid for, the income to be returned by the vendor will be that proportion of each instalment payment which the gross profit to be realized when the property is paid for bears to the gross contract price. Such income may be ascertained by taking as profit that proportion of the total cash collections received in the taxable year from instalment sales (such collections being allocated to the year against the sales of which they apply), which the annual gross profit to be realized on the total instalment sales made during each year bears to the gross contract price of all such sales made during that respective year. In any case where the gross profit to be realized on a sale or contract for sale of personal property has been reported as income for the year in which the transaction occurred, and a change is made to the instalment plan of computing net income, no part of any instalment payment received subsequently to the change, representing income previously reported on account of such transaction, should be reported as income for the year in which the instalment payment is received; the intent and purpose of this provision is that where the entire profit from instalment sales has been included in gross income for the year in which the sale was made, no part of the instalment payments received subsequently on account of such previous sales shall again be subject to tax for the year or years in which received. Where the taxpayer makes a change to this method of computing net income his balance-sheet should be adjusted conformably. If for any reason the vendee defaults in any of his instalment payments, and the vendor repossesses the property, the entire amount received on instalment payments, less the profit already returned, will be income of the vendor for the year in which the property was repossessed, and the property repossessed must be included in the inventory at its original cost to himself, less proper allowance for damage and use, if any. If the vendor chooses as a matter of consistent practice to treat the obligations of purchasers as the equivalent of cash, such a course is permissible.

(T. D. 3089, November 6, 1920)

Income tax—Opinion of Attorney General

Allowance for depletion in case of discovery by the taxpayer subsequent to March 1, 1913—Apportionment between lessor and lessee

1. The deduction for depletion in the case of mines, oil and gas wells, as the result of discovery on or after March 1, 1913, is allowed only to the party or parties in possession at the time of the discovery, and not to subsequent purchasers.

2. The value which may be set up in the case of the discovery of mines, oil and gas wells, pursuant to the second proviso of section 234 (*a*) (9), revenue act of 1918, to be depleted in accordance with such reasonable rules and regulations as the commissioner of internal revenue and the secretary of the treasury may prescribe according to the peculiar conditions in each case, is, in the case of a lease, to be equitably apportioned between the lessor and the lessee.

The following opinion, rendered by the acting attorney general, under date of October 29, 1920, relative to the right of a lessor to share in the

depletion allowed in the case of mines, oil and gas wells, as the result of discovery on or after March 1, 1913, is published in full for your information and guidance:

DEPARTMENT OF JUSTICE

WASHINGTON, October 29, 1920.

DEAR MR. SECRETARY: This will acknowledge receipt of your letter of October 9, 1920, submitting for my opinion the question "whether the value which may be set up in the case of the discovery of mines, oil or gas wells, pursuant to the second proviso of section 234 (*a*) (9), to be depleted in accordance with such reasonable rules and regulations as the commissioner and the secretary may make according to the peculiar conditions in each case, requires that the lessor be permitted a portion of such discovery value."

Section 234 (*a*) (9) of the act of February 24, 1919, provides:

(*a*) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements according to the peculiar conditions in each case, based upon cost, including cost of development not otherwise deducted: *provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *provided, further,* That in the case of mines, oil and gas wells, discovered by the taxpayer on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the commissioner, with the approval of the secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee.

This section is properly divisible into two parts; the first part, comprising all but the last sentence thereof, deals exclusively with the establishment of a basis for the determination of allowance for depletion, and the second, contained in the last sentence alone, apportions the allowance, when same shall have been determined, between the lessor and the lessee in case of leases.

The bases for allowances provided for in part 1 are:

(1) Where the property was acquired after March 1, 1913, as the result of purchase of a proven tract or lease, the cost, including cost of development not otherwise deducted, is determinative of the amount of the allowance.

(2) Where the property was acquired prior to March 1, 1913, as the result of the purchase of a proven tract or lease, the fair market value on March 1, 1913, is to be taken as the basis of the allowance for depletion, in lieu of cost up to that date.

(3) Where the property was at the time of its acquisition unproven, and discovery was made thereon after March 1, 1913, the allowance is to be determined by the fair market value at the date of discovery or within 30 days thereafter, provided that the discovery was made by the party, or parties, in possession (the taxpayer).

I take it that the phrase "discovered by the taxpayer" must be read with the phrase "and not acquired as the result of purchase of a proven tract or lease"; and taken together they mean that if a discovery is made after March 1, 1913, upon an unproven tract, acquired either before or after that

date, the allowance is to be determined by the discovery value only where the discovery was made by the party or parties in possession; that is, only when no transfers of the tract or lease have intervened between the date of the discovery and the incidence of the tax. In other words, if A, either owning or leasing a property, makes discovery thereon after March 1, 1913. and continues in possession, then the allowance for depletion is to be based upon the discovery value; but if after discovery made the property is transferred to B, then the cost is determinative of the allowance to B, since there is "acquisition after March 1, 1913, as the result of purchase of a proven tract or lease."

By "discovered by the taxpayer on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease," congress intended to provide a basis for determination of what should be the depletion allowance, and did not attempt to determine, as between a lessee and a lessor, which of them should be entitled to the allowance for discovery value. That is provided for in the last sentence of the section, which says that "In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee." Such interpretation gives effect to all the language of the section, and brings all parts of it into accord; and under the general rules of construction such interpretation should be adopted in preference to an interpretation which results in repugnance. To hold that by the language "discoverd by the taxpayer" congress intended to give the discovery allowance to the actual discoverer, and to deny the lessor any part of such allowance on the theory that the lessee is usually the discoverer, would be repugnant to language of the latter portion of the section, which in the case of leases equitably apportions the allowance between lessor and lessee.

My conclusion, therefore, is that "the value which may be set up in the case of the discovery of mines, oil or gas wells, pursuant to the second proviso of section 234 (*a*) (9), to be depleted in accordance with such reasonable rules and regulations as the commissioner and the secretary may make according to the peculiar conditions in each case," requires that the lessor be permitted a portion of such discovery value.

Respectfully,

Wm. L. Frierson, *Acting Attorney General.*

Hon. David F. Houston,
Secretary of the Treasury.

Students' Department

EDITED BY H. A. FINNEY

DECEPTIVE AVERAGES

Editor, Students' Department:

SIR: Will you please advise me in regard to the following accounting principle? In the "retail inventory system," as used in many department stores, the "inventory at cost" at the end of any month is arrived at by multiplying the amount of the retail inventory at the same date by 100% minus the average per cent of mark-up for all periods to date. In other words, inventory at cost at February 28, 1920 = retail inventory at February 28, 1920 × (100% minus per cent of mark-up for 2 months to February 28, 1920). By "retail inventory" is meant the value of the goods on hand at selling prices.

To illustrate, assume that the retail inventory at February 28, 1920, is $5,340.00, and that the per cent of mark-up to February 28, 1920, is 45.65%. Then cost of inventory at February 28, 1920, is $5,340.00 × (100% — 45.65%), or $5,340.00 × 54.35%, or $2,902.29.

Does the above method of figuring inventory at cost presume to give accurate results, or does it operate to deceive in the manner that averaging does as indicated in the article in THE JOURNAL OF ACCOUNTANCY for the month of September, 1919, page 237? If you take a carpet department where the unsold items of the inventory can be identified it will not prove out.

Yours truly,
S. C. P.

San Francisco.

Averages are very likely to be deceptive, and it seems probable that the method of approximating the cost of an inventory, as indicated in your letter, would produce inaccurate results practically every time. The reason is that with different quantities priced at different rates of write-up, you have a problem in weighted averages, with different weightings for goods purchased, goods sold and goods still in the inventory, because the goods marked at different rates of write-up are purchased, sold and on hand in varying ratios. It is probable that the concern attempting to use this method of approximating the inventory ignores the principle of weighting altogether and attempts to apply a simple average rate of write-up.

To illustrate the error which this will produce, let us assume that 500 articles are written up 20% of the selling price. That is, the 500 articles cost 80% and are priced to sell at 100%. Two articles of another class are written up 10%. That is, they cost 90% and are priced to sell at 100%. Thus we have two rates of write-up: 20% and 10%. The average of these two rates is 15%, and 100% — 15% = 85%. Now let us assume that at the end of the month one-half of the goods of each class has been sold, the other half remaining in the inventory. By applying the average rate we would value the 250 articles of the first class at 85%, although they cost only 80%; and we would value the one article of the second class at 85%, although it cost 90%. Clearly, the articles of the first group are consider-

ably over-valued, and the remaining article of the second group is considerably undervalued. It is almost certain that the over-valuation of one group will not offset the under-valuation of the other group, with the result that the inventory will be either over-valued or under-valued.

This may be made clearer by using an illustration with figures representing dollar values instead of per cents. Assume, therefore, the following facts:

Class	*Number Purchased*	*Selling price Each*	*Selling price Total*	*Write-up*	*Cost*
A	500	$200.00	$100,000.00	30%	$70,000.00
B	100	150.00	15,000.00	20	12,000.00
C	4	100.00	400.00	10	360.00
Simple average of rates of write-up..................				20	

Now, assuming that one-half of the goods of each class has been sold, the attempted approximation of the cost of the inventory would be made in the following manner and with the following incorrect results:

Class	*Number on hand*	*Selling price each*	*Selling price total*
A	250	$200.00	$50,000.00
B	50	150.00	7,500.00
C	2	100.00	200.00
Total "retail inventory"........................			$57,700.00
Multiply by (100% — 20%)........................			80%
Estimated cost			$46,160.00

But the true cost of the inventory is as follows:

Class	*Cost of purchases*	*Cost of one-half of purchases—in inventory*
A	$70,000.00	$35,000.00
B	12,000.00	6,000.00
C	360.00	180.00
Total		$41,180.00

This discrepancy may be accounted for in detail as follows:

Class	*Estimated cost = 80% of selling price*	*True cost*	*Over-valuation Under-valuation**
A	$40,000.00	$35,000.00	$5,000.00
B	6,000.00	6,000.00	
C	160.00	180.00	20.00*
Net over-valuation			$4,980.00

The error is due to the use of the simple average rate of write-up, 20%, which really applies to the goods of Class B only, and it applies to that class because the average rate happens to be the actual rate of write-up for goods of that class. The use of a weighted average rate of mark-up would produce more accurate results. Such a rate could be computed as follows:

Class	*Total cost*	*Total marked selling price*
A	$70,000.00	$100,000.00
B	12,000.00	15,000.00
C	360.00	400.00
Totals	$82,360.00	$115,400.00
Deduct cost		82,360.00
Total write-up		$33,040.00

Then 33,040.00 ÷ 115,400.00 = 28.63085%, rate of mark-up.

The rate would then be applied to the approximation of the inventory as follows:

Total inventory at selling price (as above)	$57,700.00
Multiply by 100% — 28.63085%	71.36915%
Cost of inventory	$41,180.00

This is the true cost, but it would be misleading to leave the impression that true cost could always be computed in this manner. It happens to be the true cost in this case because in addition to using a weighted average rate, which is a matter of principle, the sales were in the same ratio as the purchases. Exactly one-half of the goods of each class was sold—this is a matter of chance and would rarely be a fact. Therefore, even the use of a weighted average of the rates of write-up would rarely result in a correct calculation of the inventory, as may be seen from the following continuation of the illustration, the inventory being no longer in the same ratio as the purchases:

Approximation of inventory by proposed method

Class	*Units in inventory*	*Selling price each*	*Total selling price*
A	50	$200.00	$10,000.00
B	90	150.00	13,500.00
C	1	100.00	100.00
Total inventory at selling prices			$23,600.00
Multiply (as before) by			71.36915%
Cost by approximation			$16,843.12

Computation of true cost of inventory

Class	*Units in inventory*	*Cost each*	*Total cost*
A	50	$140.00	$ 7,000.00
B	90	120.00	10,800.00
C	1	90.00	90.00
True cost of inventory			$17,890.00

These illustrations indicate that, unless a weighted average rate or write-up is used, and unless the sales of all classes of goods are in the same ratio as the purchases of all classes, so as to make the ratio of realized gross profit the same as the ratio of write-up, this method of approximation will not produce accurate results.

Common Stock Without Par Value

Editor, Students' Department:

Sir: If consistent, I would appreciate an answer to the following:

A company is organized as a holding company, its capital stock in two classes: preferred and common without par value. The preferred, par $100.00, is sold for $80.00 with a bonus of two shares common. The company's only asset is the cash realized from these sales.

It now purchases the stock of another company, giving cash and a block of the common stock. Will you kindly outline the entries to record the above on the books of the holding company, and state at what value the common stock should be shown as issued?

Yours truly,

Chicago. J. A. O.

As to the issue of preferred stock at 80 with a bonus of common stock without par value, the preferred stock should be credited at par, cash debited for the 80 and discount on preferred stock debited for the 20. Nothing was received for the common stock, hence no credit can be made in the capital stock common account. The account with stock without par value should be credited with only those amounts actually paid in on the stock, and with any surplus transformed into fixed capital by action of the directors, such action being analogous to the declaration of a stock dividend.

The difficult question arises in states, such as Illinois, which require that a minimum amount, $5.00 per share in Illinois, shall be paid for common stock without par value. It is difficult to see how a transaction such as the one outlined in the letter could be carried out legally in such a state. It would seem that giving the common stock as a bonus would be a direct violation of the law. Possibly the difficulty might be avoided by the subterfuge of taking subscriptions to the common stock at $5.00 per share and subscriptions to the preferred stock at $70.00 per share. The subscriber would thus pay $80.00 for his one share of preferred and two shares of common as before. In that case discount on preferred stock would be debited with $30.00; the issue of the common stock would be recorded by a debit to cash and a credit to capital stock common at $5.00 per share.

If the law of the state in which the corporation is organized permits the

issue of common stock as a bonus, the balance-sheet would not show any value for the common stock until profits gave it a value. But the balance-sheet should show the number of common shares issued, and therefore a capital stock common account should be opened and memorandums made therein, stating the number of shares authorized and the number issued, but no values would be entered in the money columns.

As to the purchase of the subsidiary stock, the contract for the purchase should stipulate the value of the stock acquired. The difference between this agreed value and the cash given would be credited to the capital stock common account. Unless the value of the subsidiary stock is agreed to, it is difficult to see how the proper credit to the capital stock common account could be determined. The proper credit is the amount actually paid in for the stock, and if the property paid in is not valued there is no way of valuing the common stock when it has no book value.

Sinking Fund Contributions

Editor, Students' Department:

Sir: The writer, in going through the late Charles E. Sprague's *Accountancy of Investment,* came upon the following problem on page 185:

"On July 1, 1914, a company decides to accumulate a sinking fund of $100,000.00 by July 1, 1921, assuming that interest on the fund will be at the rate of 4% per annum. It is expected that annual contributions to the fund of $12,000.00 each will be made on July 1, 1917, 1918, 1919, 1920 and 1921. Find the two equal contributions required at July 1, 1915 and 1916, in order that the seven contributions, with accumulated interest, may amount to $100,000.00."

On the next page, Professor Sprague gives the answer as $14,103.35, but does not show how he obtains these figures. On page 184, a footnote states that these problems are in connection with the text of chapter VII, but the writer could not find any theory there covering this sort of problem.

I shall feel greatly obliged to you if you would explain how this answer is obtained.

Yours truly,
H. N. H.

Chicago.

The last five payments are an annuity, because they are equal in amount and are contributed at equal intervals. An annuity table shows that the amount of an annuity of $1.00 for five periods at 4% is $5.416323. The five payments of $12,000.00 each will therefore amount to $5.416323 × $12,000, or $64,995.88. The first two payments will have to produce the remainder of the fund, or $35,004.12.

An interest table shows that the amount of $1.00 at 4% compound interest at the end of 6 periods is $1.265319, and that the amount at the end of 5 periods is $1.216653.

Then $1.00 invested July 1, 1915, will amount to....	$1.265319
And $1.00 invested July 1, 1916, will amount to....	1.216653
Total	$2.481972

Hence \$35,004.12 ÷ 2.481972 = \$14,103.35, the amount of the two equal contributions to be made at July 1, 1915, and July 1, 1916.

Changing From Stock With Par Value to No-par Stock

Editor, Students' Department:

Sir: A corporation, having the following capital and surplus accounts, changes from a par to a non-par value:

Preferred stock: 1,400,000 shares @ \$5.00	\$ 7,000,000.00
Common stock: 3,600,000 shares @ \$5.00	18,000,000.00
Surplus:	
Capital surplus, from premium on share sold.	2,500,000.00
Earned surplus	10,000,000.00

The common stock of \$5.00 par value is to be exchanged for non-par value stock at the rate of five shares of the old for one share of the new. The argument has been advanced that the liability to set against the 720,000 shares of non-par value stock would be the par value of the old common stock plus the entire surplus, or \$30,500,000.00. I hold that the new stock should be capitalized at the figure which represents its consideration, *i. e.*, the retirement of the par value stock carried on the books at \$18,000,000.00. I do not see any advantage or necessity of closing the surplus account into capital account, as, by the very nature of the non-par plan, each share represents its aliquot part of the excess of assets over liabilities. It is my belief that the balance-sheet should reflect the new capital and surplus items in the following form:

Capital:	
7% cumulative, convertible preferred stock, 1,400,000 shares @ \$5.00 each	\$ 7,000,000.00
Balance represented by common stock, 720,000 shares without par value	18,000,000.00
Total paid-in capital	25,000,000.00
Capital surplus	2,500,000.00
Earned surplus	10,000,000.00
Total capital	\$37,500,000.00

Will you kindly give your views on the subject?

Yours truly,
H. E. M.

Tulsa, Oklahoma.

Assuming that the preferred stockholders have no claims against the surplus on account of dividends in arrears, the question as to whether the no-par value capital stock account should be credited with the par of the stock retired or with the par of that stock plus the surplus depends entirely upon the action of the directors. If they take no specific action covering the point, the credit should be for the par of the retired stock only. This is because of the probability that the courts will consider that surplus transferred to the capital stock account by action of the directors is equivalent to a stock dividend and is not available thereafter for cash dividends. So far as I know the courts have not yet decided this point, but until they do it would be a wise precaution to avoid any action which may be construed

into tying up surplus into fixed capital unless it is the desire of the directors to do so.

The account with no par value stock should be credited with the amount paid to the corporation for the common stock. The surplus account will then represent earnings. If the original common stock was issued at a premium this was virtually a part of the payment made by the holders of the no-par common stock as a contribution to the capital of the company, and on the theory that the no-par value capital stock account should be credited with what is paid in by the common stockholders, it would be logical to credit the capital stock account with such a portion of the capital surplus account as represents premiums paid on the original issue of common stock.

This case should be distinguished from the organization of a new corporation with no-par value stock for the purpose of buying the assets of an existing corporation with par-value stock. If the no-par value stock is given to the old corporation for its net assets, the value of these net assets determines the value of the no-par stock, and the total amount should be credited to the capital stock account.

Sales Cancellations and Re-sales

Editor, Students' Department:

Sir: Will you please advise me the correct way of handling re-sales made by salesmen after the goods have been charged to the account of one customer, but delivered by salesmen at destination to another customer.

Yours truly,

New Orleans. L. G. L.

Presumably the order was canceled by the first customer, and the entry for the sale should be reversed. The charge should be made to sales account and not to sales returns and allowances, because the cancellation is different in nature from a return or allowance adjustment and because the sales account would otherwise contain a duplication of sales. The sale to the new customer can then be put through the books in the customary manner.

Inventory Reserve

Editor, Students' Department:

Sir: I should like to have your idea as to the value of an account called "reserve for depreciation of merchandise," which is used in the following manner:

In a department store, at the end of every fiscal year, a certain amount, between 4% and 5% of the inventory, is set aside from the profits and credited to the account of reserve for depreciation of merchandise. The inventory has always been taken, they tell me, at cost, which in this time is lower than the market prices, and those articles that are old or damaged in any way are taken at less than cost, in proportion to the damage.

During the last three years this policy has been followed, and the store has now an amount of nearly 15% of the merchandise on hand in this account of depreciation. When making a balance-sheet it has been the custom to deduct this reserve from the total amount of the inventory in the balance-sheet itself, and the difference is what is added to the current assets. Now, I would like to know the following:

1. Whether it is proper to deduct a reserve for depreciation from the

inventory if the inventory is taken at cost less the damaged goods.

2. Whether, the reserve having been made, it is not better to call it "reserve for working capital," or "reserve for possible changes in prices," or just to add it to the regular reserve fund for contingencies and consider it in any way as a surplus account.

3. If the reserve is treated as up to now; that is, calling it depreciation and deducting it from the inventories, how is it considered by banks—as a surplus or as any other depreciation reserve like the one provided for the wear and tear of furniture and fixtures?

Any assistance you may give me in this matter will be much appreciated.

Panama R. P. G. G. S.

1. It does not seem proper to deduct a reserve for depreciation from merchandise inventories if they are priced at cost when that is lower than market, particularly when the inventory itself is written down on account of damage which has already made itself apparent in the goods. If the goods are invariably priced at cost, regardless of whether that is higher or lower than market, there would be a justification for the reserve to reduce the value to market when that is lower than cost, and it would be a proper deduction from the inventory on the balance-sheet. In that case, also, the charge required to set up the reserve would be properly made to the profit and loss account, since the drop to a lower market price is an element commonly taken into consideration in computing the operating profits for the year.

But this appears to be a reserve to provide for the contingency of future deterioration. That being the case, it does not seem proper to deduct the reserve from the inventory, as the result is an under-statement of the present value of the merchandise. In such a reserve the three following points should be borne in mind:

(a) The reserve should not be cumulative. Some reserves are cumulative, such as those for depreciation of fixed assets. Others are temporary only, such as the reserve for bad debts. A reserve set up against an inventory applies to that inventory alone and must be dropped when a new inventory is taken. An illustration may clarify this. If the inventory at December 31, 1917, is $100,000.00, a 5% reserve against this inventory would have a credit of $5,000.00. If, at December 31, 1918, the inventory is only $80,000.00, the reserve should be reduced to $4,000.00. At December 31, 1919, if the inventory is $120,000.00, the reserve should be raised to $6,000.00. Thus, the reserve is always 5% of the inventory when the books are closed. This is the only logical way, because there is no possible reason on December 31, 1919, for having a reserve which is the accumulation of $5,000.00 at the end of 1917, $4,000.00 at the end of 1918 and $6,000.00 at the end of 1919.

(b) The reserve should be set up by a charge to surplus and not to profit and loss. If the inventory is priced at cost or market, whichever is lower, and if accrued deterioration is allowed for in valuing the goods, all elements affecting the current operations of the period will thereby have been taken into consideration. Any further provision for future losses should be treated as an appropriation of surplus for purposes of conserva-

tism. Increases or decreases in the reserve, caused by changes in the amount of the inventory, should therefore be adjusted through surplus account at the end of the period.

(c) On the balance-sheet, the reserve should be so placed as to be easily recognized as an appropriation of surplus as a conservative provision for losses which may possibly occur instead of as a deduction from an asset on account of losses which have already taken place.

2. It would be improper to call the reserve a reserve for working capital or a reserve for possible changes in prices, since the reserve is not set up for either of those purposes. It is a reserve for contingencies, but the use of the term "reserve fund" is to be avoided, because a fund is supposed to be an asset.

3. If the reserve is treated as a deduction from the inventory and called a reserve for depreciation, I do not think you could blame a bank for considering it as a proper deduction from the inventory in ascertaining the true value thereof.

Reserves and Surplus

Editor, Students' Department:

Sir: The Z Corporation decides to take over the X Corporation, issuing for the asset values acquired capital stock in the amount of $600,000.00, which represents all of the stock of the Z Corporation. This is common stock and has a par value of $100.00. The statement presented by the X Corporation is in summary form as follows:

X Corporation

Assets	$700,000.00	Liabilities	$100,000.00
		Reserve for depreciation	40,000.00
		Reserve for additions	60,000.00
		Surplus	200,000.00
		Capital stock	300,000.00
	$700,000.00		$700,000.00

Certain accounts receivable appear on the books amounting to $100,000.00, which the X Corporation guarantees to the extent of $90,000.00, as being representative of the amount which would be collected. You are requested to submit the opening entries for the Z Corporation.

Will you please explain the above problem, and show how it would be worked?

Yours truly,
A. F. M.

The opening entries of the Z Corporation would be:

Subscriptions	$600,000.00	
Capital stock		$600,000.00

To record the subscription for the entire issue of our stock.

Accounts receivable	$100,000.00	
Other sundry assets	560,000.00	
Goodwill	50,000.00	

Liabilities		$100,000.00
X Company guarantee reserve for bad debts.		10,000.00
X Corporation, vendor		600,000.00

To record the purchase of all the assets of the X Company and the assumption of its liabilities. The X Company guarantees the accounts receivable of a face value of $100,000.00 to the extent of $90,000.00 only, thus establishing the value thereof for purposes of the contract of sale. Payment to be made in our stock.

X Corporation, vendor	600,000.00	
Subscriptions		600,000.00

To record the payment of subscriptions and the cancellation of our indebtedness to the X Company by applying the right of offset.

The reserve for depreciation is not carried over to the books of the new company, because it presumably took the fixed assets at their depreciated value, and that value would be the cost to it. If it took them over at some other value, the goodwill account would be inversely increased or decreased, but the reserve for depreciation would not be brought over to the new books.

The guarantee reserve for bad debts is necessarily set up because the Z Corporation must put the accounts receivable on its books at their face; it cannot write the accounts down to $90,000.00 because it does not know which ones will prove bad. It takes them over, however, at a net value of $90,000.00, since that is the guaranteed value. These accounts should be kept separate from new accounts arising from sales by the Z Corporation, because losses to the extent of the guarantee are chargeable to the vendor's reserve, and because any collections in excess of the $90,000.00 would necessitate an adjustment of the goodwill account.

The "reserve for additions" on the X Company's books is appropriated surplus. As the Z Corporation is not bound by the action of the X Corporation, the reserve may be ignored. In order to carry it to the Z Corporation's books as surplus appropriated for additions, the debit to goodwill would have to be increased $60,000.00, which would be very bad accounting.

Profits on Deferred Payment Sales

Editor, Students' Department:

Sir: Will you kindly answer the following question through the *Students' Department?* A company sells its product on three years' credit, payable in three yearly instalments. The cost of production for one year is $10,987,600.00; sales, $13,210,900.00; various expenses, $223,300.00. Find an equitable method of stating profits for the year.

My opinion is that the profit is $2,000,000.00, obtained as follows:

Sales	$13,210,900.00
Cost of sales	10,987,600.00
Gross profit	$ 2,223,300.00
Expenses	223,300.00
Net profit	$ 2,000,000.00

I do not see that the three years' credit has anything to do with the amount of profit, except for the fact that only a small amount of actual cash is received and is available for dividends.

Yours truly,
A. E. H.

Minneapolis.

There are several reasons why it would be inadvisable to take up the entire $2,000,000.00 as a profit of the year in which the sales were made. In the first place, there is practically no doubt that some of the accounts will be lost—and no provision has been made out of the $2,000,000.00 for bad debts. In the second place, the next three years will have to bear a considerable amount of expense in collecting these accounts for the benefit of the year which made the sales. The $2,000,000.00 profit should certainly be diminished by reserves for bad debts and for collection expense.

But when credits extend over such a long period it is difficult to make an accurate estimate of the necessary provisions for bad debts and collection expenses. Moreover, future years may be called on to pay interest on borrowed funds to carry on the business, because of the fact that the company's capital is tied up in long term credits. For these reasons it is desirable to take up the profits on the basis of cash collections.

The cost of sales represents 83.17 + % of the selling price. Hence, it may be assumed that 83.17% of all collections represent a return of cost, while 16.83% represents profits. During each of the years over which these accounts extend, 16.83% of the collections would be treated as income, against which would be charged the losses on bad debts, the collection expense and the interest payments. The remaining 83.17% would be treated as a return of the cost of the goods sold.

While it may be theoretically more accurate to take up the profit in the year in which the sales were made, setting up reserves for expenses and losses to be borne in future years on account of these sales, the inability to estimate the reserve accurately makes the cash collection basis expedient.

Capitalizing Preliminary Expense

Editor, Students' Department:

Sir: In the books of a prominent real-estate concern, I found an account called "real-estate acreage," debited with purchase price, interest paid on mortgages, real-estate taxes, expenses for transportation, "for sale" signs and sundry other expense items. The acreage was bought some time ago and no sales have been made. I am now told to charge 6% on the entire disbursements (debits).

I would appreciate hearing from you as to whether the recording as

enumerated is correct. My contention is that all disbursements, except purchase price, should be taken out of the asset account, and separate nominal accounts should be opened for the respective expenses, which would be closed to profit and loss at the end of the year. I further object to the charge of 6% interest. More than one of the office force do not agree with me, stating that the cost of the property is as recorded and should be capitalized and, when the company offers for sale any property not yielding any income, 6% on investment ought to be added.

Yours truly,
Brooklyn, New York. S. M.

It is generally considered that all the actual expenditures necessary to bring an enterprise to the condition when sales can be begun are part of the cost of the plant or of the article sold. Applied to real estate, these expenditures would include payment for all improvements, such as grading, paving, sidewalks, etc. As it takes time to develop the property, taxes paid or accrued are an essential part of the cost. As the land cannot develop itself, the salaries of those who supervise the work are also added. Interest actually paid during development is usually considered a legitimate element of cost.

But all this is confined to money actually paid and only during the time necessary to develop. If the property is ready for sale at the end of one year, the officers cannot sit down and draw salaries and charge them to the cost of the property, nor can they so charge taxes and other expenses. In no circumstances can they charge to the cost of the property any interest that is not actually paid or payable to an outside party. If they could, an absurd situation might arise. Suppose the capital of a company is $200,000.00, and that $150,000.00 thereof has been invested in a fruit farm which will not be productive for five years. If it were legitimate to charge 6% interest to the cost of the property, an entry could be made each year charging the property account and crediting profit and loss with $9,000.00. The next step might be to declare and pay a dividend of 4½%. Such a dividend certainly would not be legitimate.

Short Method for Computing Interest on Instalment Notes

Editor, Students' Department:

Sir: I have been told to use the following rule in computing the interest on instalment notes given in payment for automobiles. The intention is to charge simple interest, not compound interest. The rule works out correctly, but I should like to have you explain why it does.

Short method to ascertain the amount of the interest at the rate of 6% per annum upon the unpaid balance of a sum to be paid off in equal monthly payments:

Rule: To the sum or principal add one payment; multiply by the total number of months and divide the result by 400.

Example: Sum or principal, $500.00. To be paid off in 10 equal monthly payments of $50.00.

Solution: $\$500.00 + 50.00 = \$550.00.$
$\$550.00 \times 10 = \$5{,}500.00.$
$\$5{,}500.00 \div 400 = \$13.75.$

I do not see why we add one payment to the principal, and where we obtain the 400.

Yours truly,
T. W. B.

This rule would be clearer if it were stated as follows:

First step: to the original principal add one monthly payment; multiply by the number of payments, and divide by 2. The result is the sum of the various monthly amounts which draw interest.

$500.00 + $50.00 = $550.00.
$550.00 × 10 = $5,500.00.
$5,500.00 ÷ 2 = $2,750.00.

This is merely an application of the principle of arithmetical progression, using the rule: to find the sum of a series, where each successive number in the series increases or decreases by a common difference, add the first and last terms of the series, multiply by the number of terms in the series, and divide by two.

The $2,750.00 is the sum of the monthly amounts which bear interest at 6%. This fact may be shown thus:

Unpaid principal drawing interest the—

First month	[illegible]
Second month	[illegible]
Third month	[illegible]
Fourth month	[illegible]
Fifth month	[illegible]
Sixth month	[illegible]
Seventh month	[illegible]
Eighth month	[illegible]
Ninth month	[illegible]
Tenth month	[illegible]
Sum of the series	[illegible]

Second step: as each diminishing principal bears interest for one month, the total interest will be one month's interest at 6% per annum on $2,750.00. One month's interest is one-half of 1%. Hence, divide $2,750.00 by 200, obtaining $13.75 as the interest.

Two steps combined, as stated in the rule:

> To the original principal add one monthly payment, and multiply by the number of payments.
>
> Divide by 2 and then by 200; or simply divide by 400.

Treasury Stock

Editor, Students' Department:

Sir: I was recently confronted with a problem in a C. P. A. preparatory course in which I am enrolled as a student, the correct answer to which hinges upon the correct theory of entering treasury stock.

A corporation, having issued its capital stock at par, buys its own shares at 95, etc. It was the intention of this corporation to resell this stock at a higher figure, if possible. In making my entry for the purchase of this stock,

I placed the 1,000 shares on the books at par, with an offsetting entry to cash and treasury stock surplus, to which the teacher made objection, and stated that treasury stock should be entered at cost.

Will you kindly inform me which method is correct—whether treasury stock should be entered at par or at cost?

Yours truly,
C. L. H.

Everett, Massachusetts.

There is considerable difference of opinion among accountants as to whether treasury stock should be carried on the books at par or at cost. It is the opinion of this department that par is the proper figure. The reason is that when treasury stock is acquired by purchase the capital of the corporation is automatically reduced and the treasury stock should be deducted from the capital stock on the balance-sheet, carrying out the amount of the stock outstanding. Unless the treasury stock is carried on the books and deducted on the balance-sheet at par, the amount carried out in the balance-sheet as outstanding will not be the par of the stock.

Putting treasury stock on the books at par will necessitate entries for the difference between par and purchase price. When the stock is purchased for more than par, the excess should be debited to surplus. When it is acquired at less than par, the credit should not be put to surplus until a re-sale makes the difference a realized increment of surplus. Even then it is better to credit capital surplus because the item is not an operating gain. At the time of the purchase the difference between par and cost should be credited to contingent profit on treasury stock. If the stock is sold at less than par the difference would be charged to this contingent profit account; if the balance represents a gain it should be credited to capital surplus to close the contingent profit account.

Indiana Examinations

Editor, Students' Department:

Sir: Will you be so kind as to inform me whether the state of Indiana grants a C. P. A. degree or has any legislation on the subject, and if so from whom I may obtain the qualifications, date of examination and other necessary information?

Yours truly,
G. B.

Indiana grants a C. P. A. degree and uses the examinations of the American Institute of Accountants. You can obtain information by addressing Lawrence F. Orr, secretary of the Indiana state board of accountancy, State House, Indianapolis, Indiana.

Contingent Stock Donation

Editor, Students' Department:

Sir: As subscriber to The Journal of Accountancy I request that you answer the following through the *Students' Department:*

1. The directors of a corporation make an agreement with a stockholder whereby the stockholder consents to donate an amount of preferred stock to be cancelled for the purpose of creating a surplus, with the under-

standing that when a surplus is earned a bonus of common stock shall be issued to the stockholder. How would such a transaction be shown upon the books?

2. Can a corporation purchase stock above par from its employees?

Yours truly,
J. W. O.

I do not see how the donation of stock can be made to produce a surplus unless the donation is unconditional. If the stock is given to the company outright, the credit may be made to surplus; but when there is an agreement to make repayment in common stock at a later time, even though that agreement is dependent upon a contingency, there is no outright gift, and a contingent liability has been created instead of surplus. It would seem to me, therefore, that the charge to treasury stock should be offset by a credit to an account showing the name of the stockholder and the nature of the account as a contingent liability payable in common stock.

Unless the credit is made to a liability account there will be no record justifying the bonus of common stock to the stockholder at a subsequent time. The bonus could not be recorded as a dividend and charged to surplus because all stockholders of the same class must be treated alike in the matter of dividends.

A corporation can purchase its own stock from anyone at any price, unless the law of the state in which it is organized prohibits corporations from owning their own stock.

Self-Balancing Ledger

Editor, Students' Department:

Sir: The term "self-balancing ledger" has come to my attention. I would greatly appreciate any information that you may be able to furnish on the subject.

Yours truly,
C. M. T.

A self-balancing ledger is a subsidiary ledger which contains an account which is an exact duplicate of the controlling account in the general ledger except that it is kept in reverse. To illustrate: the subsidiary ledger with accounts receivable could be made self-balancing by posting the totals of the accounts receivable columns in the books of original entry twice—once to the controlling account in the general ledger and again to an account in the subsidiary ledger. But items posted to the debit of the controlling account in the general ledger are posted to the credit of the general or total account in the subsidiary ledger. Thus it will have a credit balance equal to the sum of the debit balances of the individual accounts, and a trial balance can be drawn from the subsidiary ledger. The self-balancing feature has the advantage of enabling the subsidiary bookkeeper to test the accuracy of his work without being obliged to refer to the controlling account in the general ledger.

Book Reviews

ACCOUNTS IN THEORY AND PRACTICE, by EARL A. SALIERS. *McGraw-Hill Book Company,* New York. 300 pp.

PRINCIPLES OF ACCOUNTING, by ALBERT CLAIRE HODGE and JAMES OSCAR McKINSEY. *The University of Chicago Press,* Chicago. 389 pp.

It is worth noting that of late years increasing numbers of books on accounting are being written by educators rather than by professional practitioners. This is natural in view of the growing number of accounting courses being installed in our colleges and universities. Aside from the number of young men intending to make accountancy their profession, it is being realized everywhere that knowledge of the principles of accounting is a very necessary part of the equipment for any business or profession. At present, courses in bookkeeping and accounting are mainly a part of general business courses, where they, frankly, are not courses leading to a C. P. A. certificate and accountancy as a profession; but already we see movements in other departments of university teaching to include them as subsidiary but necessary—witness the recent establishment of a new industrial engineering course at Columbia university, which includes the study of accounting, business law, corporation finance and factory costs.

Naturally it follows that we have books written by members of the teaching staff of these accounting departments. They are text-books pure and simple, and one does not as a rule find anything new or startling in them in the way of theory or practice. But it would be a mistake to pronounce them superfluous because they teach merely what has been established as standard by professionals. These writers are practically pioneers blazing the pedagogical ways of accountancy, and as active practitioners have after long years standardized theory and practice, so must the educators gradually standardize the methods of teaching them.

It is in this light that we must consider two books on theory and practice of accounting which have lately come to the reviewer's desk—one showing the method of teaching the subject at Yale university by Professor Saliers, and the other at the University of Chicago by Messrs. Hodge and McKinsey. We have purposely taken the two together because they illustrate so clearly the point we make in the above paragraph. The two methods are practically the same as far as the subject (theory and practice) is concerned. Both have practice problems at the close of each chapter well calculated to test the student's grasp of the principles set forth; and both are well buttressed with bibliographies of standard authorities. But while Professor Saliers begins with the simplest forms of books of original entry, and proceeds, step by step, in the building up of accounts and an accounting system to the final profit and loss statement and balance-sheet,

Messrs. Hodge and McKinsey exactly reverse the process, beginning with the balance-sheet and working back to the books of original entry. The reasons for this novel method given (on page 191) by the latter do not seem convincing to us, but we must decline to be dogmatic about it in the absence of any comparative statistics, say the percentage of those from each institution who have successfully passed the American Institute of Accountants examinations. It is true in both cases that the books are intended rather for those who will become in time business executives than for those seeking accountancy as a profession; nevertheless, the successful proportion of the latter who do take the institute examinations would furnish a fairly good test. Be that as it may, however, here are two distinct and diametrically opposed methods of teaching the same subject. It remains for time and experience to tell which should be regarded as the better.

Professor Saliers' book is an admirably concise and logical presentation of the theory of accounts, one that it is a pleasure to read, aside from its educational features. There is a good index, and its make-up, barring a few printer's errors. is excellent. It is intended to cover the first semester of a college year, and includes the main theory of accounting, with accompanying drills in simple practice, and will be followed by a second to cover more complicated aspects of accounting practice, thus completing a whole year's course.

Messrs. Hodge and McKinsey's book covers about the same ground, in reverse order as we have said, as Professor Saliers' first volume, but goes into much more detail, as in the matter of forms of vouchers, cheques, etc. Principles are correctly stated and the practice problems very good, but the book is not easy reading, to say the least. Owing to its novel form there is much referring to later matter, and, conversely, repetition and referring back to earlier matter—a feature the more exasperating because the book contains no index beyond the preliminary table of contents by chapters. That, we admit, might be no disadvantage to the student who is supposed to have mastered and assimilated what has gone before, but it is manifestly destructive of all logical development of a thesis to the ordinary reader.

A striking difference between the books is that Professor Saliers discusses accounting theory broadly with an eye on the legal aspect of it, while Messrs. Hodge and McKinsey devote a large amount of space to the minutiæ of a business office. Both features are valuable and necessary, as a casual inspection of the questions in recent institute examinations will prove. It is not easy to draw the line between pure accounting theory and commercial law, on the one hand, and between theory and mere business devices on the other; though the last may well come under the broad term of practice.

W. H. Lawton.

MATHEMATICS FOR THE ACCOUNTANT, by Eugene R. Vinal. *The Biddle Publishing Company,* New York. 175 pp.

Probably not a few would-be candidates for the American Institute of Accountants or C. P. A. examinations have been more or less puzzled, if

not daunted, by the inclusion of actuarial problems in the examination papers. It is only recently that books on accounting theory and practice have contained the elementary formulas and instructions dealing with compound interest which are the basis of all actuarial science. Most authors have contented themselves with a few tables showing the comparative results where the effect of compound interest is recognized or ignored, as the case may be, and relegated the whole subject to that field of higher mathematics restricted to life insurance and "mathematical sharks." Curiously enough very few seemed to realize that, once mastered, actuarial formulas are actually labor-saving devices worth knowing.

With the vast accumulation of bond issues with varying maturities, provisions for sinking funds, loans repayable in instalments, etc., it is becoming a matter of necessity for the public accountant to familiarize himself with compound interest and annuity formulas—in other words, to acquire the elements of actuarial science. Professor Vinal's book contains a short course on this subject prepared expressly for accountants. Beginning with preliminary suggestions (which will be decidedly helpful to any junior in his daily grind), the author leads us step by step, and logically, through simple interest, averaging accounts, foreign exchange, logarithms, compound interest, annuities, sinking funds, valuation of assets and amortization to the valuation of bonds as the climax. Additional chapters explain the use of the slide rule and contain review problems and problems taken from institute examination papers. Many of the subjects of these chapters are, of course, handled in any good book on accounting theory on an arithmetical basis. The virtue of Professor Vinal's method is that they are all reduced to a set of labor-saving formulas.

The author promises in a later edition that a collection of formulas shall appear as a separate chapter, a needed improvement.

It is perhaps well to suggest to intending purchasers that tables of logarithms are necessary in order to work out many of the problems submitted. There is only one table (of ten-place logarithms of the interest ratios) in Professor Vinal's book, though we can see no reason why a later edition should not contain the regular tables of logarithms, thus making it not only a text-book for the student but a valuable tool of trade for his working years.

W. H. Lawton.

BUSINESS LAW, by Thomas Conyngton. *The Ronald Press,* New York. Two volumes. 800 pp.

Of the making of laws, as of books, there is no end, as anyone familiar with the enormous output of congress, the state legislatures, municipalities, utility boards, boards of health, education, etc., can testify. We are all subject to these manifold laws and regulations, and it is a maxim of the law that ignorance of them excuses no man—a maxim which under the limitations of an average lifetime induces a lively sympathy with Mr. Bumble's famous aphorism "The law is a hass!" It has been said, and no doubt with truth, that every one of us is unwittingly guilty of violating some

law or local regulation every day of his life. Nevertheless, while one may with some self-respect be ignorant of the fact that he is violating a law when he employes a boy under fourteen as a caddy, offers a cigarette to his son, a minor, or fails to include in his income-tax return the value of sundry balls won by superior skill at golf, "yet," says Mr. Coyngton, "from this unwieldy mass of law may be elicited perhaps certain guiding principles that everyone should know—general rules that will guide us safely past most of the difficult places. Knowing these it is possible for a man so to shape his business course and his relations with his fellows as to have little to do with courts or lawyers." pp. iii-iv). It is with such principles, particularly with regard to business relations, that the book deals. It is by no means an easy subject to handle, and for its successful result requires the experience of one who is both lawyer and practical business man. This experience the author is fortunate enough to possess, and that the book has reached a second edition within two years is evidence that it is fulfilling its purpose.

It cannot be too strongly emphasized that this book is not to be classed with that enticing form of popular fiction denoted by such titles as "Every man his own lawyer!" On the contrary, one cannot give the book an intelligent reading without gaining the strong impression that no important contract or business engagement should be undertaken without competent legal advice. On the other hand a thorough understanding of the legal principles explained in the book will save many from taking foolish steps, or incurring useless and unavailing expense in trying to evade the legal consequences of their own ignorance.

Mr. Conyngton's book is well-known to the public accountancy profession, and is recommended for study by those who seek to enter it, so there is hardly any need for detailed description of it in these pages. It is especially adapted for study by those who are seeking the C. P. A. certificate, in that each chapter closes with review questions which are largely taken from old examination papers. W. H. Lawton.

NEW COLLECTION METHODS, by E. H. Gardner. *The Ronald Press,* New York. 467 pp.

A public accountant can hardly be expected to undertake the task of installing a modern credit department, yet as his diagnosis of a moribund business may indicate "poor collections" to be the chief cause of the patient's alarming condition, the prescription of Mr. Gardner's book might well be in order. As in medicine, so in business, the doctor may not always be able to work a cure, but he can frequently point out the way, after which it is up to the patient. All of which is to say that Mr. Gardner's book is certainly worth a place in the public accountant's working library—if only to suggest ways of collecting his own bills!

The fact that the book is in its second edition indicates sufficiently that it fills the need of a practical manual of procedure for the credit-man. Mainly it is descriptive of methods and forms used by some of our most successful wholesalers and mail-order houses in making collections promptly

and systematically. Ordinarily this would furnish dry reading to those not interested in the subject, but Mr. Gardner has succeeded in making it interesting to the general reader by his study of the practical psychology underlying the various methods of prodding reluctant debtors.

The only consistent thing about human life apparently is its inconsistency. Therefore, perhaps one should not be astonished by curious contradictions one encounters in the book, such as the statement: "To go to a cash basis would set back the clock by centuries" (p. 26). The aim of the credit department being to shorten the terms of credit as much as possible, it would be logical to consider the cash basis as the ultimate goal to be obtained. If it is argued that the retailer should have a reasonable time in which to turn over his stock, the obvious retort is that he should either have sufficient working capital of his own to tide him over or else look to the banks, which are the proper purveyors of credit. Again, after reading the praises of high moral standing and frankness in commercial life, it jars a bit to note the instances of saying one thing while meaning something entirely different, as shown in some of the form letters which Mr. Gardner quotes. This may be tact, but it irresistibly reminds one of the cynical definition of tact—"the ability to lie like a diplomat." Still, if business is competition and competition is but but a form of war, we must give the credit-man his due for endeavoring in his field to eliminate the frightfulness of the verbal bludgeon in favor of the more skillful and no less deadly play of the rapier. W. H. L.

BONDS AND THE BOND MARKET. March number, *The Annals of the American Academy of Political and Social Science,* published by *The American Academy of Political and Social Science,* Philadelphia.

The number of the *Annals* in question has as much of an appeal to the student as to the present or the prospective investor. One is impressed with the orderly and scholarly arrangement and presentation as well as the quality of the material offered. The first part analyzes and discusses bonds as financial investments, and describes the media and mechanism whereby bonds are brought to the investor. The second part differentiates the various classes of American government and corporate bonds. These articles are by well-known persons whose practical experience in the field of finance makes the contributions the more authoritative and valuable. The third part, on foreign government bonds, is especially illuminating and interesting. It helps to open up a vista which Americans must needs have if America is to take her place in the affairs of international finance. It helps one, incidentally, to think about domestic problems which are now so complicated by international relations. The balance of the number is made up of miscellaneous articles, the outstanding of which are *The Effect of Taxation on Securities, History of Bond Prices,* and *Causes Affecting the Value of Bonds.*

Whoever conceived the idea of making the March number of the *Annals* a treatise on bonds and the bond market conferred a favor on society. It

brings together in a very coherent manner much information which formerly was widely scattered. It adds some things which, so far as the reviewer is aware, formerly did not exist. JOHN RAYMOND WILDMAN.

STATISTICS IN BUSINESS, by HORACE SECRIST. *McGraw-Hill Book Company,* New York.

Dr. Secrist follows up his larger work—*An Introduction to Statistical Methods,* which was noticed in the September, 1918, issue of THE JOURNAL OF ACCOUNTANCY—with a small handbook for the use of executives in business. Doubtless it might, as the author hopes, be of use in schools of commerce, but personally we should prefer to see the student secure the broader foundation of the author's earlier volume. As a manual for the business-man, however, it is all that such a book should be. Any intelligent man can grasp the fundamental principles quickly and readily, and in the illustrations of graphs and charts he will have little difficulty in finding something suited to his needs.

The book tells how to gather pertinent statistics, how to analyze them, how to chart them, and finally how to use the charts to the best advantage. The most helpful chapter to the average business man is the second, *The Facts of Business,* which tells him generally what kind of facts he needs and where he may find them. Simple as that may sound to the average reader, the author has nevertheless elaborated a most important fact, viz:—that statistics to be of practical use must be gathered very largely from outside the business concern. Internal statistics are necessary and useful, but unless they are related to external facts and conditions governing the trade, all progress is necessarily haphazard. Most business-men realize this more or less, but have been ignorant of where such facts could be obtained. To such this chapter will be an eye-opener. W. H. L.

COST AND WAGE RATE BOOK, published by the *Special Purpose Book Company,* New York, 1919.

There is nothing particularly new or startling about this book so far as the reviewer knows. Rate books have been used for many years, perhaps many centuries. Interest tables were probably the first representation of this form of book. Latterly the activity in cost accounting has created a demand for tables, especially those having to do with wages. The book in question appears to be serviceable in computing labor costs. It might also be used, perhaps somewhat more laboriously, in making material calculations. The rates begin at ten cents and increase by intervals of one-half cent until they reach one dollar. Beyond that and up to a dollar and twenty-five cents they increase by intervals of two and a half cents. For each cent or half cent of increase there is shown the amount corresponding to each hour or fraction thereof, the fractions being scaled to tenths except in the cases of one-quarter and three-quarters.

Any one who has a deal of computing to do would undoubtedly find the book useful. It should appeal especially, as is suggested, to timekeepers,

estimators, engineers, surveyors, contractors and cost accountants. The auditor might find it of help in cases where there are many calculations to check.

JOHN RAYMOND WILDMAN.

R. A. O. A. NINETEEN-TWENTY SYNOPSIS, edited by E. R. WOODSON, secretary, Railway Accounting Officers' Association, 1116 Woodward building, Washington, D. C.

This book is a synopsis of decisions and recommendations relating to freight, passenger and disbursement accounting, covering from July, 1888, to May, 1920. It deals with one phase of railway accounting—interline traffic—and is confined to primary reports to be made by station agents and accountants for interline billing, accounting and auditing.

It is surprising at first to read in *The Railway Age* that "this is the first book of its kind ever published," but the first paragraph of the book (p. 10) explains succinctly the obstacles which the R. A. O. A. had to overcome in persuading the railroads to adopt a uniform interline system. The recital of these obstacles will arouse reminiscent and sympathetic emotions in the mind of the accountant who has ever taken part in a similar movement for uniform accounting. We have the word of *The Railway Age* that the compiler of the book has been eminently successful in his work, and certainly a cursory perusal of many paragraphs carries the impression that the rules laid down are clear and unambiguous.

Though the manual is intended primarly for the use of railway agents and auditors, it is well worth study by the public accountant, if only to get valuable hints how to handle so complicated a matter tersely and lucidly.

W. H. L.

GRAIN EXPORT CALCULATION TABLES, by FREDERICK H. BAUGH. *The John Hinrichs Cable Code Company,* Baltimore.

If any excuse is required for Mr. Baugh's handy little book (102 pp. and small enough to carry in one's pocket) it will be found in the opening paragraphs of the preface:

"Owing to the wide fluctuations of commodity prices and exchange rates, existing tables for figuring grain exports have become inadequate.

"To compile a book of tables by former methods * * * would require approximately 5,000 pages."

The export grain trade is surely under heavy obligations to Mr. Baugh for this labor-saving device. Public accountants auditing concerns in this trade will need it in verifying sales.

W. H. L.

INCORPORATED ACCOUNTANTS' YEAR-BOOK FOR 1920.

The Incorporated Accountants' Year-Book, issued by the council of the Society of Incorporated Accountants and Auditors of Great Britain, contains the names of 2,910 members, of whom all but 446 are residents of Great Britain. The year-book contains the usual information in regard to regulations, etc., of the society.

HOW TO AUDIT. *The McArdle Press, Inc.,* New York.

A manual of instruction originally prepared for the staff of and under the supervision of a firm of accountants and auditors. The book is an attempt at the practical, though it may better be said to discuss certain purely mechanical processes without in any way getting at the fundamentals of the science of auditing. The four sections of the book cover (a) the general rules of conduct for the auditor, (b) general instructions covering the conduct of an audit, (c) peculiar conditions to be looked for in particular businesses, and (d) suggested paragraphs for use in writing a report.

We are informed that "the mere presentation of a financial statement is seldom enough," and then are furnished with some 125 stereotoyped paragraphs to insert verbatim in writing the report. It at first seemed odd to us that the author's name appeared nowhere in the book, but after a short perusal the reason was obvious. For the commercializer of accounting practice the book will have a real appeal. For the accountant who considers himself a member of a learned and honorable profession, who desires to give his client more than a report of stereotyped paragraphs, it can have no appeal. It is to be regretted that such a book has made its appearance in accounting literature. J. H. J.

American Association of University Instructors in Accounting

The American Association of University Instructors in Accounting is to hold its fifth annual meeting at Haddon Hall, Atlantic City, December 28 and 29, 1920. The programme as arranged by H. T. Scovill, of the university of Illinois, includes the following:

Tuesday, December 28, morning session, beginning at 10 A. M., aim and scope of courses in cost accounting, income-tax procedure and graduate and research work in accounting. The afternoon session, Tuesday, will be devoted to a discussion of the relation of the University Accounting Instructors' Association to other organizations interested in accounting education, such as the American Institute of Accountants, correspondence schools and private business enterprises.

Wednesday, December 29, morning session, beginning at 9:30, profits and income and revision of federal taxation. The afternoon is reserved for a short business session, followed at 3 P. M. by a discussion of teaching methods in accounting. Twenty-five of the leading accounting educators of the country are to take part in the programme.

An invitation is extended to all interested in accounting education to attend the meeting.

Theodore I. Schneider announces the change of his firm name from Frank Loeb Schneider Company to Theodore I. Schneider Company, and the removal of offices from 220 Fifth avenue to 1140 Broadway, New York.

Correspondence

Accounting Terminology

Editor, The Journal of Accountancy:

SIR: I write to ask if you will be good enough to bring to the attention of the readers of THE JOURNAL OF ACCOUNTANCY the action taken at the annual meeting of the American Institute of Accountants last month, which led to the appointment by the president of the institute of a special committee on accounting terminology.

With your permission I should like to outline the present plans of the committee, which are, of course, subject to modification, and to ask the coöperation not only of the members of the accounting profession but of others who are interested in the matter of securing a uniform terminology. The need for this work is so generally recognized that it is unnecessary to enlarge upon this point here, and it will be sufficient to say that the use of accounting to the commercial world in America has increased so largely in the last few years, partly on account of the work connected with income-tax returns, that the need is greater than ever and appears to be recognized on all sides.

The plans on which the committee is at present working are as follows:

The preparation of a preliminary list of words and expressions to be defined. This will be gathered from actual practice and from the general accounting literature, full use being made of the excellent reports of the previous committees. It now looks as though the list will include at least five hundred or six hundred words. This preliminary list being prepared, the committee proposes to select some of the expressions which are in daily use, such as: assets, liabilities, income, profits, etc., and to define these in all their varieties. This list will itself be a fairly long one, as some of the titles, such as assets and expenses, will probably include eighteen or twenty sub-titles, such as available assets, quick assets, etc.

The committee will collect the best existing definitions for each one of these expressions, and will then decide upon the particular definition which appeals to the committee as a whole. The result of this will be such that, if we take the word "assets" for example, we shall have probably eighteen or twenty definitions of the various kinds of assets which occur in practice. These definitions we propose having multigraphed and sent to a fairly large list of correspondents, asking them for their suggestions and criticisms. Upon these being received, the committee will take them as a whole and review them—making a final list of definitions which will in turn be submitted to the institute for its approval.

In addition to having these correspondents, the committee would like to use the bulletins of the institute for the preliminary publication of these definitions as they are determined.

When the work is completed, which will probably take a year or more,

the institute will then have a complete set of definitions as nearly representative of the best ability of the profession as can be secured, and it is hoped that this will prove to be of sufficient value to warrant publication in book form by the institute and with its endorsement.

In order to enlarge the scope of this work, the committee proposes to secure the widest coöperation possible, so as to put the work on the broadest basis, and, with this in view, we propose to take the matter up with the following bodies or classes of correspondents:

1. The government departments, particularly the income-tax unit, federal trade commission, interstate commerce commission, securing, if possible, their approval of the definitions assigned to them.

2. State public service or utility commissions, such as those of New York, Wisconsin and Massachusetts.

3. The heads of the commercial departments of the various universities throughout the country from Harvard to California.

4. The various leading accounting schools throughout the country.

5. Institutes or societies representing allied professions, such as the National Institute of Cost Accountants, National Railway Accountants' Association, National Society of Municipal Officers, and engineering societies.

6. A few of the leading firms engaged in appraisals and efficiency work.

7, The accounting societies of Great Britain and Canada.

8. Those trade associations which have adopted uniform systems of accounting.

9. A select list of individuals, including members of the council of the institute and former members of the committee on terminology of the old American Association of Public Accountants.

The committee realizes that the general acceptance of any set of defiinitions can be best secured by obtaining expressions of opinion from as wide a range as is possible; for any attempt to force individual ideas would deprive the work of its chief value. On this account, therefore, it not only offers to accept, but urgently begs, that suggestions and criticisms of all kind be sent to it by any who are interested in the matter. These may be forwarded to any member of the committee, but for the sake of convenience it may be better to address them to the undersigned, in addition to whom the other members are Edward H. Moeran, of 120 Broadway, New York, and John Flint, of 50 Pine street, New York.

Yours truly,

WALTER MUCKLOW, *Chairman,*

56 U. S. Trust Company, Jacksonville, Fla.

John M. Palm, James B. Aiken and Belton B. O'Neall announce the formation of a partnership under the title of Palm, Aiken & O'Neall, with offices in the Southern Life building, Greenville, South Carolina.